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LESSON-1

FINANCIAL SYSTEMS AND MARKETS

STRUCTURE

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1.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Understand the various concepts of financial system

(b) Highlight the developments and weakness of financial system in India

1.1 INTRODUCTION

A system that aims at establishing and providing a regular, smooth, efficient and cost effective linkage between depositors and investors is known as financial system. The functions of financial system are to channelise the funds from the surplus units to the deficit units. An efficient financial system not only encourages savings and investments,


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it also efficiently allocates resources in different investment avenues and thus accelerates the rate of economic development. The financial system of a country plays a crucial role of allocating scare resources to productive uses. Its efficient functioning is of critical importance to the economy.

1.2 CONCEPT OF FINANCIAL SYSTEM

Financial system is one of the industries in an economy. It is a particularly important industry that frequently has a far reaching impact on society and the economy. But if its occult trappings are stripped it is like any industry, a group of firms that combine factors of production (land, labour and capital) under the general direction of a management team and produce a product or cluster of products for sale in financial market. The product of the financial industry is not tangible rather it is an intangible service. Financial industry as a whole, produces a wide range of services but all these services are related directly or indirectly to assets and liabilities, that is, claims on people, organization, institutions, companies and government. These are the forms in which people accumulate much of their wealth. In simple terms we are referring to paper assets : shares, debentures, deposits, mortgages and other securities. Thus, financial system performs certain essential functions for the economy, including maintenance of payment system (through which purchasing power is transferred from one participant to another i.e. from buyer to seller), collection and allocation of the savings of society, and creation of a variety of stores of wealth to suit the preferences of savers. This brief sketch of functions of financial system gives us its gist. Performance of these functions pre-supposes the existence of financial assets, financial institutions (intermediaries) and financial markets. A combination of these three constitute financial system.

To interpret the financial system and evaluate its performance, it requires an understanding of its functions in an economy. Financial system in fact has the following functions :

a) Capital formation function

This is the process of diversion of the productive capacity of the economy to the making of capital goods which increase future productive capacity. Process of capital formation involve three distinct but inter-dependent activities : savings, finance and investment.

b) Allocative function

The financial system in process of capital formation has to decide as to how capital is to be used. Poor choice in deciding which economic projects are to be embarked upon, leads to wastage of resources. The better the quality of judgment exercised in allocation, the more rapid economic progress will be.

c) Service function

An effective financial system offers the economic segments services in form of providing opportunities to hold wealth in secured and convenient way so that they pay a positive rate of return. The availability of these services of the financial system contributes importantly, if in an intangible way, to the satisfaction of consumers.

Finance is the flowing blood in the body of financial system. It is a link between savings and investments by providing the mechanism through which savings (claims to resources) of savers are pooled and are put into the hands of those able and willing to invest by financial intermediaries. Financial intermediaries create assets that have property of liquidity or convertibility into a fixed amount of money on demand. Liquidity refers to cash, money and nearness to cash. Liquidity is the most significant aspect of financial intermediation while holding essentially illiquid assets themselves, intermediaries are able to create liquid assets to be held by the ultimate savers in the economy. Illiquid assets refer to credit creation. In Indian economy Central Bank (RBI in India) performs the function of cash creation where as financial institutions create credit.

Flow of finance in the system takes place between two segments i.e. Surplus Unit and Deficit Unit as shown in Chart I. Surplus unit, having excess of income over current consumption can be public surplus unit or private surplus unit. The former have savings through normal budgetary channels and the retained earnings of public sector enterprises. The latter refer to household savings and non-corporate sector savings but corporate sector savings are dominating in volume. Corporate sector savings depend mainly on profitability and distribution policy of the enterprise. On the other hand size of household savings is a function of capacity, ability and willingness of the people to save which in return depends on numerous factors like psychological, social, economic. On the other end of flow of fund, we have deficit unit which seeks funds for investment or consumption purposes. Their investment and sometimes consumption pattern is outcome of their strategy about future earnings. This in turn is a function of existing stock of capital, state of industry and economy, government policies, potentials of opportunity for new investments. Government and business sector are the major borrowers whose investment normally surpass their savings.

The role of financial system is thus, to promote savings and their channalisation in the economy through financial assets that are more productive than the physical assets. The fund flows in an efficient financial system from less productive to more productive purpose, from unproductive/less productive activities to productive activities and from idle balance to active balances. Thus, ultimate objective is to add value through flow of fund in the system. This means that the operations of financial system are vital to the pace and structure of the growth of the economy. However we must not forget that some of the transfers are to households to acquire consumer goods and services and to government for assorted purposes, including collective consumption. This system plays a significant role in accelerating the rate of economic development which leads to improving general standard of living and higher social welfare.

There is another way to look at financial system. Financial system makes it easier to trade. People trade because they differ in what they have and in what they want. Trade

may be *trade in lending* (giving up purchasing power now in exchange for purchasing power in the future), *trade in risk* (reducing economic burden of risks through insurance and forward transactions) and *trade in goods*. Trade benefits everyone. Thus, financial system is concerned with every one and every one is interacting with the system, consciously or unconsciously. Financial system makes trade easier through its *technology of payments* (whether through credit or cash), *technology of lending* (through financial market or direct lending) and *technology of risk* (taking up insurance policy or contracting in futures market). Technology basically refers to network of institutions, markets and instruments of financial system.

Financial system is changing very fast. Changes are due to two types of innovations. First category of innovation facilitates serving existing needs in new ways. An example is leasing, which enables the user to use the asset without buying it. Second category of innovation uses existing technology to serve new needs. Securitisation of financial assets is an example here. Funds extended in form of loans are tied up. To make use of such tied up funds these financial assets are securitised and liquid resources are raised to extend more loans.

Another dimension of financial system in an economy is the government. It is the government which lays down the rules of the game for financial system i.e. directs how the markets operate, which are permissible instruments and what are operating constraints of financial intermediaries. Intervention of government has two facets : one is *ensuring efficiency* in the system and second is providing *stability and building confidence*. A financial system is said to be efficient when the sum of all gains from lending, payment and trade in risk are as large as they can be. An immature financial system needs higher degree of intervention and vice-versa. Government also intervenes in financial system to provide its stability in absence of which the system breaks down and it can be disastrous. There has to be a limit to governmental intervention. Excessive intervention mars innovations. Innovations in financial system is the result of attempts to get out of the restrictive regulations. It is essential to appreciate role of financial system or sector in an

economy. As the economy grows, the set up and operations of this systems changes. The major role as discussed earlier has been resources mobilization. An efficient financial system facilitate raising huge amount through even small contributions from large number of investors. A firm can raise Rs. 100 crore through issue of 10 crore shares being subscribed by investors with minimum contributions of Rs. 2000 being issue of minimum 200 shares of Rs. 10 each or through a mutual fund or financial institutions. Large amount can be mobilized from small investors. The instruments issued to raise fund may have maturity patterns which are different for the investor's need. To over come such situation secondary markets emerge as special part of financial system. To minimize the risk associated with investment, financial system offers a wide variety of investment opportuniting enabling investor to diversify their investment hence risk.

1.3 FINANCIAL CONCEPTS

An understanding of the financial system requires an understanding of the following concepts:

(i) Financial assets

(ii) Financial intermediaries

(iii) Financial markets

(iv) Financial rates of return

(v) Financial instruments

1.3.1 Financial Assets

In any financial transaction, there should be a creation or transfer of financial assets. Hence, the basic product of any financial system is the financial asset. A financial assets is one which is used for production or consumption or for further creation of assets. For instance, A buys equity shares and these shares are financial assets since they earn income in future.

In this context, one must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning income. For example X purchases land and building, or gold or silver. These are physical assets since they cannot be used for further production. Many physical assets are useful for consumption only.

It is interesting to note that the objective of investment decides the nature of the asset. For instance if a building is bought for residence purpose, it becomes a physical asset. If the same is bought for hiring, it becomes a financial asset.

Classification of Financial Assets

Financial assets can be classified differently under different circumstances. One such classification is :

(i) Marketable assets

(ii) Non-marketable assets

Marketable Assets : Marketable assets are those which can be easily transferred from one person to another without much hindrance. Examples are shares of listed companies, Government securities, bonds of public sector undertakings etc.

Non-Marketable Assets : On the other hand, if the assets cannot be transferred easily, they come under this category. Examples are bank deposits, provident, funds, pension funds, National Savings Certificates, insurance policies etc.

Yet another classification is as follows:

(i) Money or cash asset

(ii) Debt asset

(iii) Stock asset

Cash Asset : In India, all coins and currency notes are issued by the RBI and the Ministry of Finance, Government of India. Besides, commercial banks can also create money by means of creating credit. When loans are sanctioned, liquid cash is not granted.

Instead an account is opened in the borrower's name and a deposit is created. It is also a kind of money asset.

Debt Asset : Debt asset is issued by a variety of organizations for the purpose of raising their debt capital. Debt capital entails a fixed repayment schedule with regard to interest and principal. There are different ways of raising debt capital. Example are issue of debentures, raising of term loans, working capital advance, etc.

Stock Asset : Stock is issued by business organizations for the purpose of raising their fixed capital. There are two types of stock namely equity and preference. Equity shareholders are the real owners of the business and they enjoy the fruits of ownership and at the same time they bear the risk as well. Preference shareholders, on the other hand get a fixed rate of dividend (as in the case of debt asset) and at the same time they retain some characteristics of equity.

1.3.2 Financial Intermediaries

The term financial intermediary includes all kinds of organizations which intermediate and facilitate financial transactions of both individual and corporate customers. Thus, it refers to all kinds of financial institutions and investing institutions which facilitate financial transactions in financial markets. They may be in the organized sector or in the unorganized sector. They may also be classified into two :

(i) Capital market intermediaries

(ii) Money market intermediaries

Capital Market Intermediaries : These intermediaries mainly provide long term funds to individuals and corporate customers. They consist of term lending institutions like financial corporations and investing institutions like LIC.

Money Market Intermediaries : Money market intermediaries supply only short term funds to individuals and corporate customers. They consist commercial banks, co-operative banks, etc.

1.3.3 Financial Markets

Generally speaking, there is no specific place or location to indicate a financial market. Wherever a financial transaction takes place, it is deemed to have taken place in the financial market. Hence financial markets are pervasive in nature since financial transactions are themselves very pervasive throughout the economic system. For instance, issue of equity shares, granting of loan by term lending institutions, deposit of money into a bank, purchase of debentures, sale of shares and so on.

However, financial markets can be referred to as those centers and arrangements which facilitate buying and selling of financial assets, claims and services. Sometimes, we do find the existence of a specific place or location for a financial market as in the case of stock exchange.

Classification of Financial Markets

The classification of financial markets in India is shown in Chart II.

(a) Unorganised Markets

In these markets there are a number of money lenders, indigenous bankers, traders etc., who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc., whose activities are not controlled by the RBI. Recently the RBI has taken steps to bring private finance companies and chit funds under its strict control by issuing non-banking financial companies (Reserve Bank) Directions, 1998. The RBI has already taken some steps to bring the unorganized sector under the organized fold. They have not been successful. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardized.

(b) Organised Markets

In the organized markets, there are standardized rules and regulations governing their financial dealings. There is also a high degree of institutionalization and

instrumentalisation. These markets are subject to strict supervision and control by the RBI or other regulatory bodies.

These organized markets can be further classified into two. They are :

(i) Capital market

(ii) Money market

Capital Market : The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three namely :

(i) Industrial securities market

(ii) Government securities market and

(iii) Long term loans market

I. Industrial securities market

As the very name implies, it is a market for industrial securities namely: (i) Equity shares or ordinary shares, (ii) Preference shares, and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are :

(i) Primary market or New issue market

(ii) Secondary market or Stock exchange

Primary Market : Primary market is a market for new issues or new financial claims. Hence it is also called New Issue market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long term funds. Thus, primary market facilitates capital formation.

There are three ways by which a company may raise capital in a primary market. They are :

(i) Public issue

(ii) Rights issue

(iii) Private placement

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

Secondary Market : Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act, 1956. The Bombay Stock Exchange is the principal stock exchange in India which sets the tone of the other stock markets.

II. Government Securities Market

It is otherwise called Gilt-Edged securities market. It is a market where Government securities are traded. In India there are many kinds of Government Securities-short term and long term. Long term securities are traded in this market while short term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi-Government authorities like City Corporations, Port Trusts. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

Government securities are issued in denominations of Rs.100. Interest is payable half-yearly and they carry tax exemptions also. The role of brokers in marketing these securities is practically very limited and the major participant in this market in the

"commercial banks" because they hold a very substantial portion of these securities to satisfy their S.L.R. requirements.

The secondary market for these securities is very narrow since most of the institutional investors tend to retain these securities until maturity.

The Government securities are in many forms. These are generally:

(i) Stock certificates or inscribed stock

(ii) Promissory Notes

(iii) Bearer Bonds which can be discounted.

Government securities are sold through the Public Debt Office of the RBI while Treasury Bills (short term securities) are sold through auctions.

Government securities offer a good source of raising inexpensive finance for the Government exchequer and the interest on these securities influences the prices and yields in this market. Hence this market also plays a vital role in monetary management.

III. Long Term Loans Market

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long term loans market may further be classified into :

(i) Term loans market

(ii) Mortgages market

(iii) Financial Guarantees market

Term Loans Market : In India, many industrial financing institutions have been created by thee Government both at the national and regional levels to supply long term and medium term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India. Institutions like IDBI, IFCI, ICICI, and other state financial corporations come under this category. These institutions meet the growing and varied long-term financial requirements of industries by supplying

long term loans. They also help in identifying investment opportunities, encourage new entrepreneurs and support modernization efforts.

Mortgages Market : The mortgages market refers to those centers which supply mortgage loan mainly to individual customers. A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one. Again it may be a first charge or second charge. Equitable mortgage is created by a mere deposit of title deeds to properties as security whereas in the case of legal mortgage the title in the property is legally transferred to the lender by the borrower. Legal mortgage is less risky.

Similarly, in the first charge, the mortgager transfers his interest in the specific property to the mortgagee as security. When the property in question is already mortgaged once to another creditor, it becomes a second charge when it is subsequently mortgaged to somebody else. The mortgagee can also further transfer his interest in the mortgaged property to another. In such a case, it is called a sub-mortgage.

The mortgage market may have primary market as well secondary market. The primary market consists of original extension of credit and secondary market has sales and re-sales of existing mortgages at prevailing prices.

In India residential mortgages are the most common ones. The Housing and Urban Development Corporation (HUDCO) and the LIC play a dominant role in financing residential projects. Besides, the Land Development Banks provide cheap mortgage loans for the development of lands, purchase of equipment etc. These development banks raise finance through the sale of debentures which are treated as trustee securities.

Financial Guarantees Market : A Guarantee market is a center where finance is provided against the guarantee of a reputed person in the financial circle. Guarantee is a contract to discharge the liability of a third party in case of his default. Guarantee acts as a security from the creditor’s point of view. In case the borrower fails to repay the loan,

the liability falls on the shoulders of the guarantor. Hence the guarantor must be known to both the borrower and the lender and he must have the means to discharge his liability.

Though there are many types of guarantees, the common forms are : (i) Performance Guarantee, and (ii) Financial Guarantee. Performance guarantees cover the payment of earnest money, retention money, advance payments, non-completion of contracts etc. On the other hand financial guarantees cover only financial contracts.

In India, the market for financial guarantees is well organized. The financial guarantees in India relate to :

(i) Deferred payments for imports and exports

(ii) Medium and long term loans raised abroad

(iii) Loans advanced by banks and other financial institutions

These guarantees are provided mainly by commercial banks, development banks, Governments both central and states and other specialized guarantee institutions like ECGC (Export Credit Guarantee Corporation) and DICGC (Deposit Insurance and Credit Guarantee Corporation). This guarantee financial service is available to both individual and corporate customers. For a smooth functioning of any financial system, this guarantee service is absolutely essential.

Importance of Capital Market

Absence of capital market acts as a deferent factor to capital formation and economic growth. Resources would remain idle if finance are not funneled through capital market. The importance of capital market can be briefly summarized as follows :

(i) The capital market serves as an important source for the productive use of the economy’s savings. It mobilizes the savings of the people for further investment and thus avoids their wastage in unproductive uses.

(ii) It provides incentives to saving and facilitates capital formation by offering suitable rates of interest as the price of capital.

(iii) It provides an avenue for investors, particularly the household sector to invest in financial assets which are more productive than physical assets.

(iv) It facilitates increase in production and productivity in the economy and thus enhance the economic welfare of the society. Thus, it facilitates "the movement of stream of command over capital to the point of highest yield" towards those who can apply them productively and profitably to enhance the national income in the aggregate.

(v) The operations of different institutions in the capital market induce economic growth. They give quantitative and qualitative directions to the flow of funds and bring about rational allocation of scarce resources.

(vi) A healthy capital market consisting of expert intermediaries promotes stability in values of securities representing capital funds.

(vii) Moreover, it serves as an important source for technological up gradation in the industrial sector by utilizing the funds invested by the public.

Thus, a capital market serves as an important link between those who save and those who aspire to invest these savings.

Money Market

Money market is a market for dealing with financial assets and securities which have a maturity period of upto one year. In other words, it is a market for purely short term funds. The money market may be subdivided into four. They are:

(i) Call money market

(ii) Commercial bills market

(iii) Treasury bills market

(iv) Short term loan market

Call Money Market : The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on

demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Bombay, Calcutta, Madras, Delhi, Ahmedabad etc. The special feature of this market is that the interest rate varies from day to day and even from hour to hour and centre to centre. It is very sensitive to changes in demand and supply of call loans.

Commercial Bills Market : It is a market for bills of exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

In India the bill market is under-developed. The RBI has taken many steps to develop a sound bill market. The RBI has enlarged the list of participants in the bill market. The Discount and Finance House of India was set up in 1988 to promote secondary market in bills. In spite of all these, the growth of the bill market is slow in India. There are no specialized agencies for discounting bills. The commercial banks play a significant role in this market.

Treasury Bills Market : It is a market for treasury bills which have ‘short-term’ maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because its repayment is guaranteed by the Government. It is an important instrument for short term borrowing of the Government. There are two types of treasury bills namely (i) ordinary or regular and (ii) adhoc treasury bills popularly known as ‘adhocs’.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short term financial needs. Adhoc treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only. Adhocs are not marketable in India but holders of these bills can sell them back to 364 days only.

Financial intermediaries can park their temporary surpluses in these instruments and earn income.

Short-Term Loan Market : It is a market where short-term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short term loans in the form of cash credit and overdraft. Overdraft facility is mainly given to business people whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But cash credit is for a period of one year and it is sanctioned in a separate account.

Foreign Exchange Market

The term foreign exchange refers to the process of converting home currencies into foreign currencies and vice versa. According to Dr. Paul Einzing "Foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another".

The market where foreign exchange transactions take place is called a foreign exchange market. It does not refer to a market place in the physical sense of the term. In fact, it consists of a number of dealers, banks and brokers engaged in the business of buying and selling foreign exchange. It also includes the central bank of each country and the treasury authorities who enter into this market as controlling authorities.

Functions : The most important functions of this market are :

(i) To make necessary arrangements to transfer purchasing power from one country to another.

(ii) To provide adequate credit facilities for the promotion of foreign trade.

(iii) To cover foreign exchange risks by providing hedging facilities.

In India, the foreign exchange business has a three-tiered structure consisting of:

(i) Trading between banks and their commercial customers.

(ii) Trading between banks through authorized brokers.

(iii) Trading with banks abroad.

Brokers play a significant role in the foreign exchange market in India. Apart from authorised dealers, the RBI has permitted licensed hotels and individuals (known as Authorised Money Changers) to deal in foreign exchange business. The FEMA helps to smoothen the flow of foreign currency and to prevent any misuse of foreign exchange which is a scarce commodity.

1.3.4 Financial Rates of Return

Most households in India still prefer to invest on physical assets like land, buildings, gold, silver etc. But, studies have shown that investment in financial assets like equities in capital market fetches more return than investments on gold. It is imperative that one should have some basic knowledge about the rate of return on financial assets also.

The return on Government securities and bonds are comparatively less than on corporate securities due to lower risk involved therein. The Government and the RBI determine the interest rates on Government securities. Thus, the interest rates are administered and controlled. The peculiar feature of the interest rate structure is that the interest rates do not reflect the free market forces. They do not reflect the scarcity value of capital in the country also. Most of these rates are fixed on an ad hoc basis depending upon the credit and monetary policy of the Government.

Generally the interest rate policy of the Government is designed to achieve the following:

(i) To enable the Government to borrow comparatively cheaply.

(ii) To ensure stability in the macro-economic system.

(iii) To support certain sectors through preferential lending rates.

(iv) To mobilize substantial savings in the economy.

The interest rate structure for bank deposits and bank credits is also determined by the RBI. Similarly the interest rate on preference shares is fixed by the Government at 14%. Normally, interest is a reward for risk undertaken through investment and at the same time it is a return for abstaining from consumption. The interest rate structure should allocate scarce capital between alternative uses. Unfortunately, in India the administered interest rate policy of the Government fails to perform the role of allocating scarce sources between alternative uses.

Recent Trends : With a view to bringing the interest rates nearer to the free market rates, the Government has taken the following steps:

(i) The interest rates on company deposits are freed.

(ii) The interest rates on 364 days Treasury Bills are determined by auctions and they are expected to reflect the free market rates.

(iii) The coupon rates on Government loans have been revised upwards so as to be market oriented.

(iv) The interest rates on debentures are allowed to be fixed by companies depending upon the market rates.

(v) The maximum rates of interest payable on bank deposits (fixed) are freed for deposits of above one year.

Thus, all attempts are being taken to adopt a realistic interest rate policy so as to give positive return in real terms adjusted for inflation. The proper functioning of any financial system requires a good interest rate structure.

1.3.5 Financial Instruments

Financial instruments refer to those documents which represent financial claims on assets. As discussed earlier, financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples are Bill of exchange, Promissory Note, Treasury Bill, Government Bond,

Deposit Receipt, Share, Debenture, etc. Financial instruments can also be called financial securities. Financial securities can be classified into:

(i) Primary or direct securities.

(ii) Secondary or indirect securities.

Primary Securities : These are securities directly issued by the ultimate investors to the ultimate savers, e.g. shares and debentures issued directly to the public.

Secondary Securities : These are securities issued by some intermediaries called financial intermediaries to the ultimate savers, e.g. Unit Trust of India and mutual funds issue securities in the form of units to the public and the money pooled is invested in companies.

Again these securities may be classified on the basis of duration as follows :

(i) Short-term securities

(ii) Medium-term securities

(iii) Long-term securities

Short-term securities are those which mature within a period of one year. For example, Bill of Exchange, Treasury Bill, etc. Medium-term securities are those which have a maturity period ranging between one and five years like Debentures maturing within a period of 5 years. Long-term securities are those which have a maturity period of more than five years. For example, Government Bonds maturing after 10 years.

Characteristic Features of Financial Instruments

Generally speaking, financial instruments possess the following characteristic features:

(i) Most of the instruments can be easily transferred from one hand to another without many cumbersome formalities.

(ii) They have a ready market i.e., they can be bought and sold frequently and thus trading in these securities is made possible.

(iii) They possess liquidity, i.e., some instruments can be converted into cash readily. For instance, a bill of exchange can be converted into cash readily by means of discounting and rediscounting.

(iv) Most of the securities possess security value, i.e., they can be given as security for the purpose of raising loans.

(v) Some securities enjoy tax status, i.e., investment in these securities are exempted from Income Tax, Wealth Tax, etc., subject to certain limits.

(vi) They carry risk in the sense that there is uncertainty with regard to payment of principal or interest or dividend as the case may be.

(vii) These instruments facilitate future trading so as to cover risks due to price fluctuations, interest rate fluctuations etc.

(viii) These instruments involve less handling costs since expenses involved in buying and selling these securities are generally much less.

(ix) The return on these instruments is directly in proportion to the risk undertaken.

(x) These instruments may be short-term or medium term or long-term depending upon the maturity period of these instruments.

1.4 DEVELOPMENT OF FINANCIAL SYSTEM IN INDIA

Some serious attention was paid to the development of a sound financial system in India only after the launching of the planning era in the country. At the time of Independence in 1947, there was no strong financial institutional mechanism in the country. There was absence of issuing institutions and non-participation of intermediary financial institutions. The industrial sector also had no access to the savings of the community. The capital market was very primitive and shy. The private as well as the unorganized sector played a key role in the provision of ‘liquidity’. On the whole, chaotic conditions prevailed in the system.

With the adoption of the theory of mixed economy, the development of the financial system took a different turn so as to fulfill the socio-economic and political objectives. The Government started creating new financial institutions to supply finance both for agricultural and industrial development and it also progressively started nationalizing some important financial institutions so that the flow of the finance might be in the right direction.

Nationalisation of Financial Institution

As we know that the RBI is the leader of the financial system. But, it was established as a private institution in 1935. It was nationalized in 1948. It was followed by the nationalization of the Imperial Bank of India in 1956 by renaming it as State Bank of India. In the same year, 245 Life Insurance Companies were brought under Government control by merging all of them into a single corporation called Life Insurance Corporation of India. Another significant development in our financial system was the nationalization of 14 major commercial banks in 1969. Again, 6 banks were nationalized in 1980. This process was then extended to General Insurance Companies which were reorganized under the name of General Insurance Corporation of India. thus, the important financial institutions were brought under public control.

Starting of Unit Trust of India

Another landmark in the history of development of our financial system is the establishment of new financial institutions to strengthen our system and to supply institutional credit to industries.

The Unit Trust of India was established in 1964 as a public sector institution to collect the savings of the people and make them available for productive ventures. It is the oldest and largest mutual fund in India. It is governed by its own statues and regulations. However, since 1994, the schemes of UTI have to be approved by the SEBI. It has introduced a number of open-ended and close-ended schemes. It also provides re-purchase facility of units of the various income schemes of UTI are linked with stock

exchanges. Its investment is confined to both corporate and non-corporate sectors. It has established the following subsidiaries:

(i) The UTI Bank Ltd., in April 1994.

(ii) The UTI Investor Service Ltd., to act as UTI's own Registrar and Transfer agency.

(iii) The UTI Security Exchange Ltd.

Establishment of Development Banks

Many development banks were started not only to extend credit facilities to financial institutions but also to render advisory services. These banks are multipurpose institutions which provide medium and long term credit to industrial undertakings, discover investment projects, undertake the preparation of project reports, provide technical advice and managerial services and assist in the management of industrial units. These institutions are intended to develop backward regions as well as small and new entrepreneurs.

The Industrial Finance Corporation of India (IFCI) was set up in 1948 with the object of "making medium and long term credits more readily available to industrial concerns in India, particularly under circumstances where normal banking accommodation is inappropriate or recourse to capital issue method is impracticable". At the regional level, State Financial Corporations were established under the State Financial Corporation Act, 1951 with a view to providing medium and long term finance to medium and small industries. It was followed by the establishment of the Industrial Credit and Investment Corporation of India (ICICI) in 1955 to develop large and medium industries in private sector, on the initiative of the World Bank. It adopted a more dynamic and modern approach in industrial financing. Subsequently, the Government of India set up the Refinance Corporation of India (RCI) in 1958 with a view to providing refinance facilities to banks against term loans granted by them to medium and small units. Later on it was merged with the Industrial Development Bank of India.

The Industrial Development Bank of India (IDBI) was established on July 1, 1964 as a wholly owned subsidiary of the RBI. The ownership of IDBI was then transferred to the Central Government with effect from February 16, 1976. The IDBI is the apex institution in the area of development banking and as such it has to co-ordinate the activities of all the other financial institutions. At the State level, the State Industrial Development Corporations (SIDCO)/State Industrial Investment Corporations were created to meet the financial requirements of the States and to promote regional development.

In 1971, the IDBI and LIC jointly set up the Industrial Reconstruction Corporation of India (IRCI) with the main objective of reconstruction and rehabilitation of sick industrial undertakings. The IRCI was converted into a statutory corporation in March 1985 and renamed as the Industrial Reconstruction Bank of India (IRBI). In 1997, the IRBI has to be completely restructured since it itself has become sick due to financing of sick industries. Now, it is converted into a limited company with a new name of Industrial Investment Bank of India (IIBI). Its objective is to finance only for expansion, diversification, modernization etc., of industries and thus it has become a development bank.

The Small Industries Development Bank of India (SIDBI) was set up as a wholly owned subsidiary of IDBI. It commenced operations on April 2, 1990. The SIDBI has taken over the responsibility of administrating the Small Industries Development Fund and the National Equity Fund.

Institution for Financing Agriculture

In 1963, the RBI set up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects such as minor irrigation, farm mechanization,, land development, horticulture, daily development, etc. However, in July 1982, the National Bank for Agriculture and Rural Development (NABARD) was established and the ARDC was merged with it. The whole

sphere of agricultural finance has been handed over to NABARD. The functions of the Agricultural Credit Department and Rural Planning and Credit Cell of the RBI have been taken over by NABARD.

Institution for Foreign Trade

The Export and Import Bank of India (EXIM Bank) was set up on January 1, 1982 to take over the operations of International Finance wing of the IDBI. Its main objective is to provide financial assistance to exporters and importers. It functions as the principal financial institution for coordinating the working of other institutions engaged in financing of foreign trade. It also provides refinance facilities to other financial institutions against their export-import financing activities.

Institution for Housing Finance

The National Housing Bank (NHB) has been set up on July 9, 1988 as an apex institution to mobilize resources for the housing sector and to promote housing finance institutions both at regional and local levels. It also provides refinance facilities to housing finance institutions and scheduled banks. It also provides guarantee and underwriting facilities to housing finance institutions. Again, it co-ordinates the working of all agencies connected with housing.

Stock Holding Corporation of India Ltd. (SHCIL)

Recently in 1987 another institution viz., Stock Holding Corporation of India Ltd. was set up to tone up the stock and capital markets in India. Its main objective is to provide quick share transfer facilities, clearing services, Depository services, support services, management information services and development services to investors both individuals and corporates. The SHCIL was set up by seven All India financial institutions viz., IDBI, IFCI, ICICI, LIC, GIC, UTI and IRBI.

Mutual Funds Industry

Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public and investing them in a diversified portfolio. They provide investment avenues for small investors who cannot participate in the equities of big companies. Mutual funds have been floated by some public sector banks, LIC, GIC and recently by private sector also.

Venture Capital Institutions

Venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. Much thrust is given to new ideas or technological innovations. Indeed it is a long term risk capital to finance high technology projects. The IDBI venture capital fund was set up in 1986. The IFCI has started a subsidiary to finance venture capital viz., The Risk Capital and Technology Finance Corporation (RCTC). Likewise the ICICI and the UTI have jointly set up the Technology Development and Information Company of India Limited (TDICI) in 1988 to provide venture capital. Similarly many State Financial Corporations and commercial banks have started subsidiaries to provide venture capital. The Indus Venture Capital Fund and the Credit Capital Venture Fund Limited come under the private sector.

Credit Rating Agencies

Of late, many credit rating agencies have been established to help investors to make a decision of their investment in various instruments and to protect them from risky ventures. At the same time it has the effect of improving the competitiveness of the companies so that one can excel the other. Credit rating is now mandatory for all debt instruments. Similarly, for accepting deposits, non-banking companies have to compulsorily go for credit rating. Some of the credit rating agencies established re :

(i) Credit Rating and Information Services of India Ltd. (CRISIL)

(ii) Investment Information and Credit Rating Agency of India Ltd. (ICRA)

(iii) Credit Analysis and Research Ltd. (CARE)

(iv) Duff Phelps Credit Rating Pvt. Ltd. (DCR India)

The rating is confined to fixed deposits, debentures, preference shares and short term instruments like commercial paper. The establishment of various credit rating agencies will go a long way in stabilizing the financial system in India by supplying vital credit information about corporate customers.

Multiplicity of Financial Instruments

The expansion in size and number of financial institutions has consequently led to a considerable increase in the financial instruments also. New instruments have been introduced in the form of innovative schemes of LIC, UTI, Banks, Post Office Savings Bank Accounts, Shares and debentures of different varieties, Public Sector Bonds, National Savings Scheme, National Savings Certificates, Provident Funds, Relief Bonds, Indira Vikas Patra, etc. Thus different types of instruments are available in the financial system so as to meet the diversified requirements of varied investors and thereby making the system more healthy and vibrant.

Legislative Support

The Indian financial system has been well supported by suitable legislative measures taken by the Government then and there for its proper growth and smooth functioning. Though there are many enactments, some of them are very important. The Indian Companies Act was passed in 1956 with a view to regulating the function of companies from birth to death. It mainly aims at giving more protection to investors since there is a diversity of ownership and management in companies. It was a follow up to the Capital Issues Control Act passed in 1947. Again, in 1956, the Securities Contracts (Regulations) Act was passed to prevent undesirable transactions in securities. It mainly regulates the business of trading in the stock exchanges. This Act permitted only recognized stock exchanges to function.

To ensure the proper functioning of the economic system and to prevent concentration of economic power in the hands of a few, the Monopolies and Restrictive Trade Practices Act was passed in 1970. In 1973, the Foreign Exchange Regulations Act was enacted to regulate the foreign exchange dealings and to control Indian investments abroad and vice versa.

The Capital Issue Control Act was replaced by setting up of the Securities Exchange Board of India. Its main objective is to protect the interest of investors by suitably regulating the dealings in the stock market and money market so as to achieve efficient and fair trading in these markets. When the Government adopted the New Economic Policy, many of these Acts were amended so as to remove many unwanted controls. Bank and financial institutions have been permitted to become members of the stock market in India. They have been permitted to float mutual funds, undertake leasing business, carry out factoring services etc.

Besides the above, the Indian Contract Act, The Negotiable Instruments Act, The Law of Limitation Act, The Banking Regulations Act, The Stamp Act etc., deserve a special mention. When the financial system grows, the necessity of regulating it also grows side by side by means of bringing suitable legislations. These legislative measures have re-organised the Indian financing system to a greater extent and have restored confidence in the minds of the investing public as well.

1.5 WEAKNESSES OF INDIAN FINANCIAL SYSTEM

After the introduction of planning, rapid industrialization has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing requirements of the Government and the industries, many innovative financial instruments have been introduced. Besides, there has been a mushroom growth of financial intermediaries to meet the ever growing financial requirements of different types of customers. Hence, the Indian financial system is more developed and integrated

today than what it was 50 years ago. Yet, it suffers from some weaknesses as listed below:

(i) Lack of Co-ordination between different Financial Institutions

There are a large number of financial intermediaries. Most of the vital financial institutions are owned by the Government. At the same time, the Government is also the controlling authority of these institutions. In these circumstances, the problem of co-ordination arises. As there is multiplicity of institutions in the Indian financial system, there is lack of co-ordination in the working of these institutions.

(ii) Monopolistic Market Structures

In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance the entire life insurance business is in the hands of LIC. The UTI has more or less monopolized the mutual fund industry. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement or lack of effort in mobilizing savings of the public and so on. Ultimately it would retard the development of the financial system of the country itself.

(iii) Dominance of Development Banks in Industrial Financing

The development banks constitute the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the financial institutions created by the Government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds, from their sponsors. As such, they fail to mobilize the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country. For industries abroad, institutional finance has been a result of institutionalization of personal savings through media like banks, LIC, pension and provident funds, unit trusts and so on. But they play a

less significant role in Indian financial system, as far as industrial financing is concerned. However, in recent times attempts are being made to raise funds from the public through the issue of bonds, units, debentures and so on. It will go a long way in forging a link between the normal channels of savings and the distributing mechanism.

(iv) Inactive and Erratic Capital Market

The important function of any capital market is to promote economic development through mobilization of savings and their distribution to productive ventures. As far as industrial finance in India is concerned, corporate customers are able to raise their financial resources through development banks. So, they need not go to the capital market. Moreover, they don't resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.

(v) Imprudent Financial Practice

The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So there is a preponderance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. To make maters worse, when corporate enterprises face any financial crises, these financial institutions permit a greater use of debt than a warranted. It is against the traditional concept of a sound capital structure.

However, in recent times all efforts have been taken to activate the capital market. Integration is also taking place between different financial institutions. For instance, the Unit Linked Insurance Schemes of the UTI are being offered to the public in collaboration with the LIC. Similarly the refinance and rediscounting facilities provided by the IDBI aim at integration. Thus, the Indian financial system has become a developed one.

1.6 SUMMARY

A system that aim at establishing and providing a regular smooth, efficient and cost effective linkage between depositors and investors in known as financial system. A financial system companies of financial institutions, financial services, financial markets and financial instruments. These constituents are closely related and work in conjuction with each others. A financial asset is one which is used for production or consumption or for further creation of assets. Financial intermediaries includes all kinds of financial institutions and investing institutions which facilitate financial transaction in financial markets. Financial markets facilitate buying and selling of financial claims, assets, services and securities. Financial market is classified into organised and unorganised markets. Financial claims such as financial assets and securities dealt in a financial market are referred to as financial instruments. Financial instruments can be classified into primary and secondary securities. With the adoption of the theory of mixed economy, the development of the financial system took a different turn as to fulfill the socio-economic and political objectives. The Government has started creating new financial institutions and it also progressively started nationalising some financial institutions so that the flow of the finance might be in the right direction. Indian financial system is more developed and integrated today than it was 50 years ago, but it suffers from some weaknesses.

1.7 KEYWORDS

Financial System: A set of complex and closely connected instructions, agents, practices, markets transactions, claims and liabilities relating to financial aspects of an economy is referred as financial system.

Financial Asset: Financial assets refer to claim of periodical payments of certain sum of money by way of payment of principal, interest or dividend.

Primary Market: It is a market for new issue of shares, debentures and bonds.

Secondary Market: The market where existing securities are traded is referred to as secondary market.

Money Market: It is a market for short-term money and financial assets that are near substitutes for money.

Capital Market: It is a market for financial assets which have a long or indefinite maturity.

Financial Instruments: Financial instruments refer to those documents which represent financial claims on assets.

1.8 SELF ASSESSMENT QUESTIONS

1. Discuss the classification of Indian financial markets and explain the features of each market.
2. Classify the various financial intermediaries functioning in the Indian financial system and bring out their features.
3. Define financial instruments? What are their characteristics?
4. Trace out the development of the financial system in India.
5. “Inspite of suitable legislative measures, the Indian financial system remains weak.” Comment.

1.9 SUGGESTED READINGS

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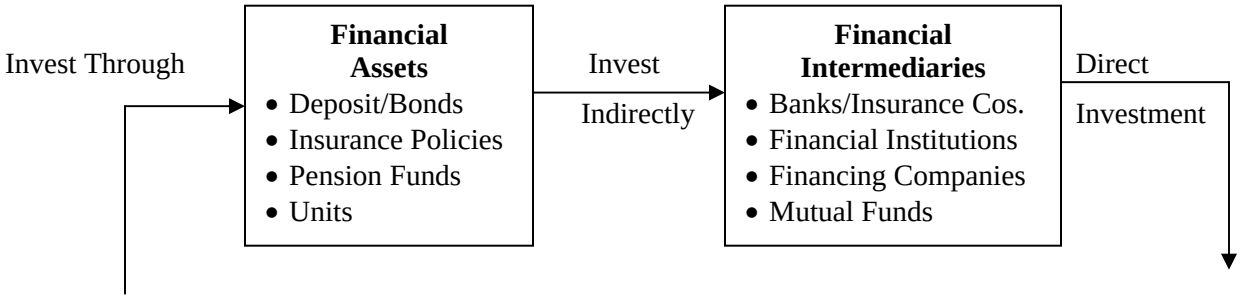
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CHART-1

WORKING OF FINANCIAL SYSTEM



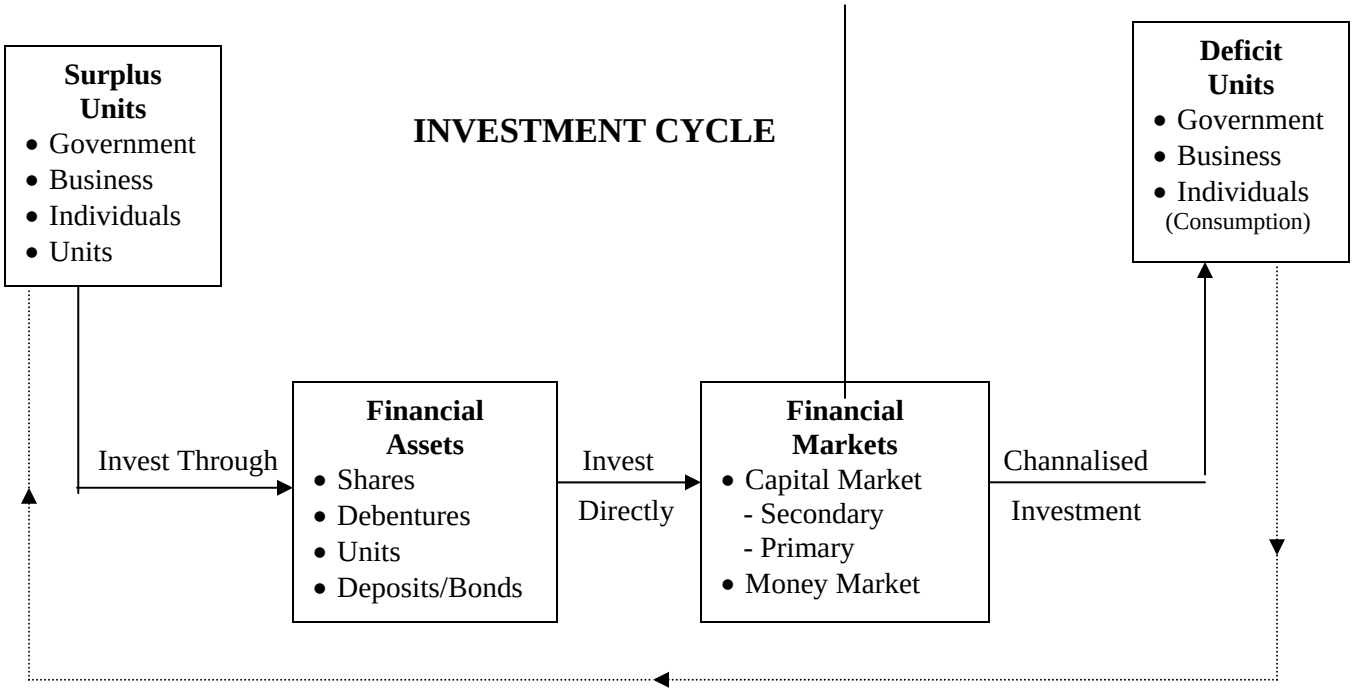
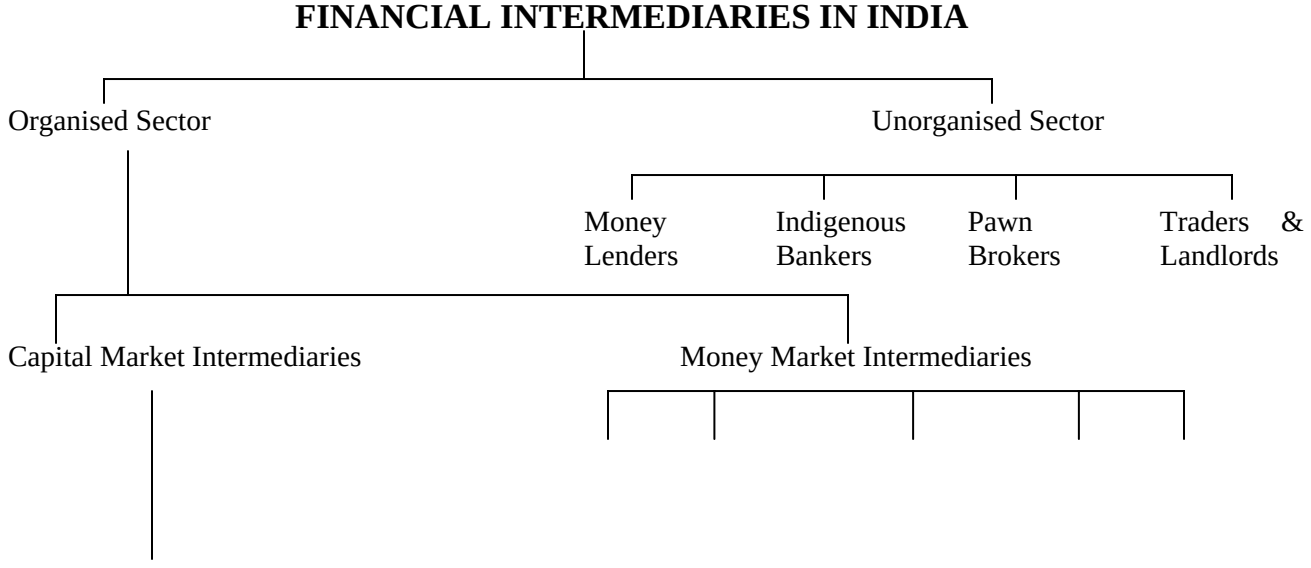


CHART-II

FINANCIAL INTERMEDIARIES IN INDIA



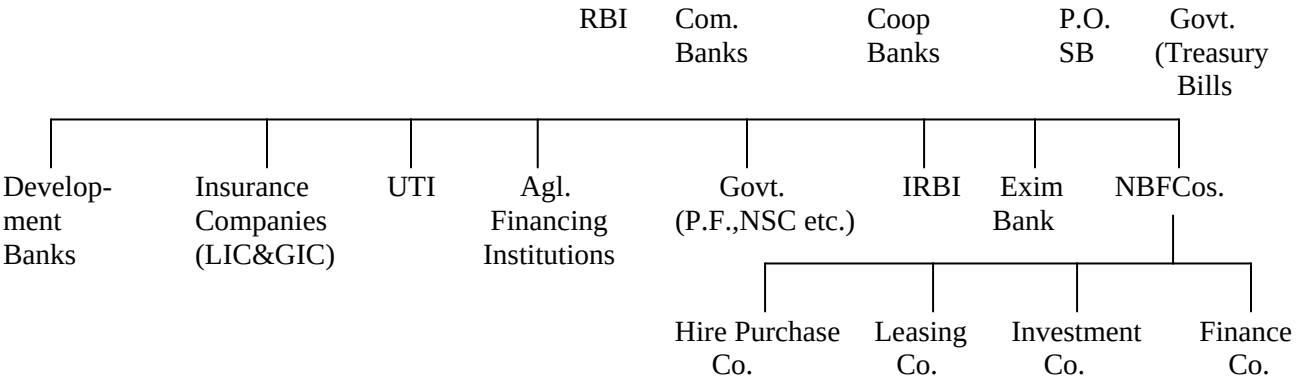
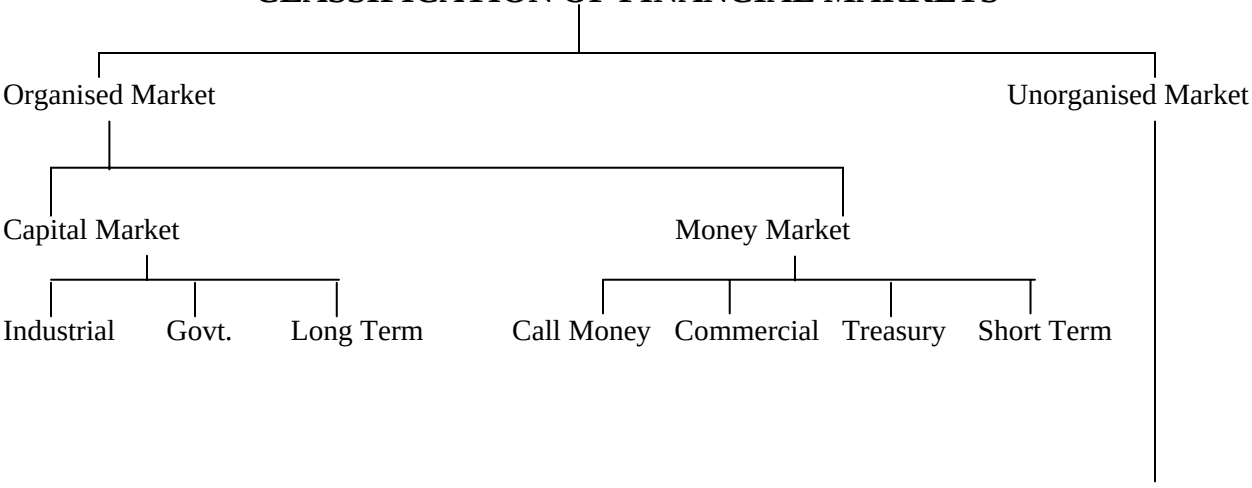
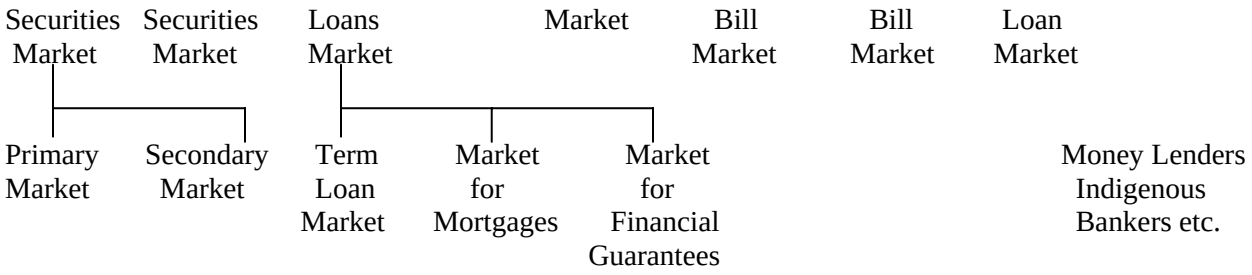


CHART-III

CLASSIFICATION OF FINANCIAL MARKETS




Securities Market
Securities Market
Loans Market
Market
Bill Market
Bill Market
Loan Market
Primary Market
Secondary Market
Term Loan Market
Market for Mortgages
Market for Financial Guarantees
Money Lenders
Indigenous Bankers etc.

Class	**:**	**MBA**	**Updated by :**	**Dr. M.C. Garg**
Course Code	**:**	**FM-404**		
Subject	**:**	**Management of Financial Services**		

LESSON-2

NATURE AND SCOPE OF FINANCIAL SERVICES

STRUCTURE

2.0 Objective
2.1 Introduction
2.2 Meaning of Financial Services
2.3 Classification of Financial Services Industry
2.4 Scope of Financial Services
2.5 Causes for Financial Innovation
2.6 New Financial Products and Services
2.7 Innovative Financial Instruments
2.8 Challenges Facing the Financial Services Sector
2.9 Present Scenario
2.10 Summary
2.11 Keywords
2.12 Self Assessment Questions
2.13 Suggested Readings

2.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define financial service and explain its scope.
(b) Discuss about the various innovative financial instruments.
(c) Describe the challenges which are being faced by financial service sector.
(d) Explain the present scenario of financial service sector in India

2.1 INTRODUCTION

There has been an upsurge in the financial services provided by various banks and financial institutions since 1990. Efficiency of emerging financial system depends upon the quality and variety of financial services provided by the banking and non-banking financial companies. Financial services, through the network of elements such as financial institutions, financial markets and financial instruments, serve the needs of individuals, institutions and corporates. It is through these elements that the functioning of the financial system is facilitated. In fact, an orderly functioning of the financial system depends, to a great extent, on the range and the quality of financial services extended by a host of providers.

2.2 MEANING OF FINANCIAL SERVICES

The Indian Financial services industry has undergone a metamorphosis since 1990. During the late seventies and eighties, the Indian financial service industry was dominated by commercial banks and other financial institutions which cater to the requirements of the Indian industry. Infact the capital market played a secondary role only. The economic liberalization has brought in a complete transformation in the Indian financial services industry.

Prior to the economic liberalization, the Indian financial service sector was characterized by so many factors which retarded the growth of this sector. Some of the significant factors were:

(i) Excessive controls in the form of regulations of interest rates, money rates etc.

(ii) Too many control over the prices of securities under the erstwhile Controller of Capital Issues.

(iii) Non-availability of financial instruments on a large scale as well as on different varieties.

(iv) Absence of independent credit rating and credit research agencies.

(v) Strict regulation of the foreign exchange market with too many restrictions on foreign investment and foreign equity holding in Indian companies.

(vi) Lack of information about international developments in the financial sector.

(vii) Absence of a developed Government securities market and the existence of stagnant capital market without any reformation.

(viii) Non-availability of debt instruments on a large scale.

However, after the economic liberalisation, the entire financial sector has undergone a sea-saw change and now we are witnessing the emergence of new financial products and services almost everyday. Thus, the present scenario is characterized by financial innovation and financial creativity and before going deep into it, it is imperative that one should understand the meaning and scope of financial services.

In general, all types of activities which are of a financial nature could be brought under the term ‘financial services’. The term “Financial Services” in a broad sense means “mobilizing and allocating savings”. Thus, it includes all activities involved in the transformation of saving into investment.

The ‘financial service’ can also be called ‘financial intermediation’ Financial intermediation is a process by which funds are moblised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Thus, financial services sector is a key are and it is very vital for industrial developments. A well developed financial services industry is absolutely necessary to mobilize the savings and to allocate them to various investable channels and thereby to promote industrial development in a country.

2.3 CLASSIFICATION OF FINANCIAL SERVICES INDUSTRY

The financial intermediaries in India can be traditionally classified into two:

(i) Capital market intermediaries and

(ii) Money market intermediaries.

The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide long term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short term funds. Hence, the term 'financial services industry' includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

2.4 SCOPE OF FINANCIAL SERVICES

Financial services cover a wide range of activities. They can be broadly classified into two namely:

(i) Traditional activities

(ii) Modern activities

Traditional activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads viz;

(i) Fund based activities and

(ii) Non-fund based activities

Fund based activities : The traditional services which come under fund based activities are the following:

(i) Underwriting of or investment in shares, debentures, bonds etc. of new issues (primary market activities)

(ii) Dealing in secondary market activities.

(iii) Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.

(iv) Involving in equipment leasing, hire purchase, venture capital, seed capital etc.

(v) Dealing in foreign exchange market activities.

Non-fund based activities : Financial intermediaries provide services on the basis of non-fund activities also. This can also be called “fee based” activity. Today, customers whether individual or corporate are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services, are being provided under this head. They include the following :

(i) Managing the capital issues i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issues.

(ii) Making arrangements for the placement of capital and debt instruments with investment institutions.

(iii) Arrangement of funds from financial institutions for the clients’ project cost or his working capital requirements.

(iv) Assisting in the process of getting all Government and other clearances.

Modern activities

Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been discussed in brief under the head ‘New financial products and services’. However, some of the modern services provided by them are given in brief hereunder:

(i) Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approval.

(ii) Planning for mergers and acquisitions and assisting for their smooth carry out.

(iii) Guiding corporate customers in capital restructuring.

(iv) Acting as Trustees to the debenture-holders.

(v) Recommending suitable changes in the management structure and management style with a view to achieving better results.

(vi) Structuring the financial collaboration/joint ventures by identifying suitable joint venture partner and preparing joint venture agreement.

(vii) Rehabilitating and reconstructing sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.

(viii) Hedging of risk due to exchange rate risk, interest rate risk, economic risk and political risk by using swaps and other derivative products.

(ix) Managing the portfolio of large Public Sector Corporations.

(x) Undertaking risk management services like insurance services, buy-back options etc.

(xi) Advising the clients on the question of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.

(xii) Guiding the clients in the minimization of the cost of debt and in the determination of the optimum debt-equity mix.

(xiii) Undertaking services relating to the capital market such as:

(a) Clearing services,

(b) Registration and transfers,

(c) Safe-custody of securities,

(d) Collection of income on securities.

(xiv) Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

Sources of revenue

Accordingly, there are two categories of sources of income for a financial service company namely: (i) fund-based and (ii) fee-based.

Fund-based income comes mainly from interest spread (difference between the interest paid and earned), lease rentals, income from investments in capital market and real estate. On the other hand, fee-based income has its sources in merchant banking, advisory services, custodial services, loan syndication etc. In fact, a major part of the income is earned through fund-based activities. At the same time, it involves a large share of expenditure also in the form of interest and brokerage. In recent times, a number of private financial companies have started accepting deposits by offering a very high rate of interest. When the cost of deposit resources goes up, the lending rate should also go up. It means that such companies should have to compromise the quality of its investments.

Fee-based income, on the other hand, does not involve much risk. But, it requires a lot of expertise on the part of a financial company to offer such fee-based services.

2.5 CAUSES FOR FINANCIAL INNOVATION

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with an increasingly volatile and uncertain market place. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons:

(i) Low profitability : The profitability of the major financial intermediary, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.

(ii) Keen competition : The entry of many financial intermediaries in the financial sector market has led to severe competition amount themselves. This keen competition

has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

(iii) Economic Liberalisation : Reform of the financial sector constitutes the most important component of India's programme towards economic liberalization. The recent economic liberalization measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

(iv) Improved communication technology : The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities. Hence, innovative products are brought into the domestic market in no time.

(v) Customer Service : Now-a-days, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public. Innovations thus help them in soliciting new business.

(vi) Global impact : Many of the providers and users of capital have changed their roles all over the world. Financial intermediaries have come out of their traditional approach and they are ready to assume more credit risks. As a consequence, many innovations have taken place in the global financial sector which have its own impact on the domestic sector also.

(vii) Investor awareness : With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds etc. Again, within

the financial assets, they go from ‘risk free’ bank deposits to risky investments in shares. To meet the growing awareness of the public, innovation has become the need of the hour.

Financial Engineering

Thus, the growing need for innovation has assumed immense importance in recent times. This process is being referred to as financial engineering. Financial engineering is the lifeblood of any financial ability. “Financial engineering is the design, the development and the implementation of innovative financial instruments and processes and the formulation of creative solutions to problems in finance”.

2.6 NEW FINANCIAL PRODUCTS AND SERVICES

Today, the importance of financial services is gaining momentum all over the world. In these days of complex finance, people expect a Financial Service Company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the injection of the economic liberation policy into our economy and the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporates and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial service company to innovate new products and service so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are discussed below :

(i) **Merchant Banking :** A merchant banker is a financial intermediary who helps to transfer capital from those who posses it to those who need it. Merchant banking includes a wide range of activities such as management of customers securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporates and thus promotes industrial development in the country.

(ii) **Loan Syndication :** This is more or less similar to 'consortium financing'. But, this work is taken up by the merchant banker as a lead-manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a Government Department. The other banks who are willing to lend can participate in the loan by contributing an amount suitable to their own lending policies. Since a single bank cannot provide such a huge sum as loan, a number of banks join together and form a syndicate. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

(iii) **Leasing :** A lease is an agreement under which a company or a firm, acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called "rental charges". The lessee cannot acquire any ownership to the asset, but he can use it and have full control over it. he is expected to pay for all maintenance charges and repairing and operating costs. In countries like the U.S.A., the U.K. and Japan equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies. In India also, many financial companies have started equipment leasing business. Commercial banks have also been permitted to carry on this business by forming subsidiary companies.

(iv) **Mutual Funds :** A mutual fund refers to a find raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing risk. The fund provides

investment avenue for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capital appreciation in the long run.

(v) Factoring : Factoring refers to the process of managing the sales ledger of a client by a financial service company. In other words, it is an arrangement under which a financial intermediary assumes the credit risk in the collection of book debts for its clients. The entire responsibility of collecting the book debts passes on to the factor. His services can be compared to a *del credre agent* who undertakes to collect debts. But, a factor provides credit information, collects debts, monitors the sales ledger and provides finance against debts. Thus, he provides a number of services apart from financing.

(vi) Forfeiting : Forfeiting is a technique by which a forfeitor (financing agency) discounts an export bill and pay ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills. The forfeitor does so without any recourse to the exporter and the exporter is protected against the risk of non-payment of debts by the importers.

(vii) Venture Capital : A venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. It is in contrast to the conventional "security based financing". Much thrust is given to new ideas or technological innovations. Finance is being provided not only for 'start-up capital' but also for 'development capital' by the financial intermediary.

(viii) Custodial Services : It is another line of activity which has gained importance, of late. Under this, a financial intermediary mainly provides services to clients, particularly to foreign investors, for a prescribed fee. Custodial services provide agency services like safe keeping of shares and debentures, collection of interest and dividend and reporting of matters on corporate developments and corporate securities to foreign investors.

(ix) Corporate Advisory Service : Financial intermediaries particularly banks have set up corporate advisory service branches to render services exclusively to their corporate customers. For instance, some banks have extended computer terminals to their corporate customers to that they can transact some of their important banking transactions by sitting in their own office. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers, this service is of immense help to the customers.

(x) Securitisation : Securitisation is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable. A financial institution might have a lot of its assets blocked up in assets like real estate, machinery etc. which are long term in nature and which are non-negotiable. In such cases, securitisation would help the financial institution to raise cash against such assets by means of issuing securities of small values to the public. Like any other security, they can be traded in the market. it is best suited to housing finance companies whose loans are always long term in nature and their money is locked up for a considerable long period in real estates. Securitisation is the only answer to convert these ill-liquid assets into liquid assets.

(xi) Derivative Security : A derivative security is a security whose value depends upon the values of other basic variables backing the security. In most cases, these variables are nothing but the prices of traded securities. A derivative security is basically used as a risk management tool and it is resorted to cover the risk due to price fluctuations by the investments manager. Just like a forward contract which is a derivative of a spot contract, a derivative security is derived from other trading securities backing it. Naturally the value of a derivative security depends upon the values of the backing securities. Derivative helps to break the risks into various components such as credit risk, interest rates risk, exchange rates risk and so on. It enables the various risk components to be identified precisely and priced them and

even traded them if necessary. Financial intermediaries can go for derivatives since they will have greater importance in the near future. In India some forms of derivatives are in operation.

(xii) New Products in Forex Market : New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them, the following are the important ones :

(a) Forward Contracts : A forward transaction is one where the delivery of a foreign currency takes place at a specified future date for a specified price. It may have a fixed maturity for e.g. 31st May or a flexible maturity for e.g. 1st to 31st May. There is an obligation to honour this contract at any cost, failing which, there will be some penalty. Forward contracts are permitted only for genuine business transactions. It can be extended to other transactions like interest payments.

(b) Options : As the very name implies, it is a contract wherein the buyer of the option has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his option. There is no obligation to buy or sell, but it is completely left to his option. Options may be of two types namely call options and put options. Under call options, the customer has an option to buy and it is the option to sell under put options. Options trading would lead to speculation and hence there are much restrictions in India.

(c) Futures : It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange. Unlike options, there is an obligation to buy or sell foreign exchange on a future date at a specified rate. it can be dealt only in a stock exchange.

(d) Swaps : A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates-say, for instance, purchase of spot and sale of forward or vice versa with different maturities. Thus swaps would result in simultaneous buying and selling of the same foreign currency of the same value for different maturities to eliminate exposure risk. It can also be used as a tool to enter arbitrage operations, if any, between two countries. It can also be used in the interest rate market also.

(xiii) Lines of Credit (LOC) : It is an innovative funding mechanism for the import of goods and services on deferred payment terms. LOC is an arrangement of financing institution/bank of one country with another institution/bank/agent to support the export of goods and services to as to enable the importers to import no deferred payment terms. This may be backed by a guarantee furnished by the institution/bank in the importing country. The LOC helps the exporters to get payment immediately as soon as the goods are shipped, since, the funds would be paid out of the pool account with the financing agency and it would be debited to the account of the borrower agency/importer whose contract for availing the facility is already approved by the financing agency on the recommendation of the overseas institution. It acts as conduct of financing which is for a certain period and on certain terms for the required goods to be imported. The greatest advantage is that it saves a lot of time and money on mutual verification of bonafides, source of finance etc. It serves as a source of forex.

2.7 INNOVATIVE FINANCIAL INSTRUMENTS

In recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. This has helped them to keep in tune with the changing times and changing customer needs. Accordingly, many innovative financial instruments have

come into the financial market in recent times. Some of them have been discussed hereunder :

(i) **Commercial Paper :** A paper is a short-term negotiable money market instrument. It has the character of an unsecured promissory note with a fixed maturity of 3 to 6 months. Banking and non-banking companies can issue this for raising their short term debt. It also carries an attractive rate of interest. Commercial papers are sold at a discount from their face value and redeemed at their face value. Since its denomination is very high, it is suitable only to institutional investors and companies.

(ii) **Treasury Bill :** A treasury bill is also a money market instrument issued by the Central Government. It is also issued at a discount and redeemed at par. Recently, the Government has come out with short term treasury bills of 182-days bills and 364-days bills.

(iii) **Certificate of Deposit :** The scheduled commercial banks have been permitted to issue certificate of deposit without any regulation on interest rates. This is also a money market instrument and unlike a fixed deposit receipt, it is a negotiable instrument and hence it offers maximum liquidity. As such, it has a secondary market too. Since the denomination is very high, it is suitable to mainly institutional investors and companies.

(iv) **Inter-bank Participations (IBPs) :** The scheme of inter-bank participation is confined to scheduled banks only for a period ranging between 91 days and 180 days. This may be ‘with risk’ participation or ‘without risk’ participation. However, only a few banks have so far issued IBPs carrying an interest rate ranging between 14 and 17 per cent per annum. This is also a money market instrument.

(v) **Zero Interest Convertible Debenture/Bonds :** As the very name suggests, these instruments carry no interest till the time of conversion. These instruments are converted into equity shares after a period of time.

(vi) **Deep Discount Bonds :** There will be no interest payments in the case of deep discount bonds also. Hence, they are sold at a large discount to their nominal value. For example, the Industrial Development Bank of India issued in February 1996 deep discount bonds. Each bond having a face value of Rs.2,00,000 was issued at a deep discounted price of Rs.5300 with a maturity period of 25 years. Of course, provisions are there for early withdrawal or redemption in which case the deemed face value of the bond would be reduced proportionately. This bond could be gifted to any person.

(vii) **Index-Linked Guilt Bonds :** These are instruments having a fixed maturity. Their maturity value is linked to the index prevailing as on the date of maturity. Hence, they are inflation-free instruments.

(viii) **Option Bonds :** These bonds may be cumulative or non-cumulative as per the option of the holder of the bonds. In the case of cumulative bonds, interest is accumulated and is payable only on maturity. But, in the case of non-cumulative bond, the interest is paid periodically. This option has to be exercised by the prospective investor at the time of investment.

(ix) **Secured Premium Notes :** These are instruments which carry no interest of three years. In other words, their interest will be paid only after 3 years, and hence, companies with high capital intensive investments can resort to this type of financing.

(x) **Medium Term Debentures :** Generally, debentures are repayable only after a long period. But, these debentures have a medium term maturity. Since they are secured and negotiable, they are highly liquid. These types of debt instruments are very popular in Germany.

(xi) Variable Rate Debentures : Variable rate debentures are debt instruments. They carry a compound rate of interest, but this rate of interest is not a fixed one. It varies from time to time in accordance with some pre-determined formula as we adopt in the case of Dearness Allowance calculations.

(xii) Non-Convertible Debentures with Equity Warrants : Generally debentures are redeemed on the date of maturity. but, these debentures are redeemed in full at a premium in instalments as in the case of anticipated insurance policies. The instalments may be paid at the end of 5th, 6th, 7th and 8th year from the date of allotment.

(xiii) Equity with 100% Safety Net : Some companies make "100% safety net" offer to the public. It means that they give a guarantee to the issue price. Suppose, the issue price is Rs.40/- per share (nominal value of Rs.10/- per share), the company is ready to get it back at Rs.40/- at any time, irrespective of the market price. That is, even if the market price comes down to Rs.30/- there is 100% safety net and hence the company will get it back at Rs.40/-.

(xiv) Cumulative convertible Preference Shares : These instruments along with capital and accumulated dividend must be compulsorily converted into equity shares in a period of 3 to 5 years from the date of their issue, according to the discretion of the issuing company. The main object of introducing it is to offer the investor an assured minimum return together with the prospect of equity appreciation. This instrument is not popular in India.

(xv) Convertible Bonds : A convertible bond is one which can be converted into equity shares at a per-determined timing neither fully or partially. There are compulsory convertible bonds which provide for conversion within 18 months of their issue. There are optionally convertible bonds which provide for conversion within 36 months. There are also bonds which provide for conversion after 36 months and they carry 'call' and 'put' features.

(xvi) Debentures with 'Call' and 'Put' Feature : Sometimes debentures may be issued with 'Call' and 'Put' feature. In the case of debentures with 'Call feature', the issuing company has the option to redeem the debentures at a certain price before the maturity date. In the case of debentures with 'Put features', the company gives the holder the right to seek redemption at specified times at predetermined prices.

(xvii) Easy Exit Bond : As the name indicates, this bond enables the small investors to encash the bond at any time after 18 months of its issue and thereby paving a way for an easy exit. It has a maturity period of 10 years with a call option any time after 5 years. Recently the IDBI has issued this type of bond with a face value of Rs.5000 per bond.

(xviii) Retirement Bond : This type of bond enables an investor to get an assured monthly income for a fixed period after the expiry of the 'wait period' chosen by him. No payment will be made during the 'wait period'. The longer the wait period, the higher will be the monthly income. Besides these, the investor will also get a lump sum amount on maturity. For example, the IDBI has issued Retirement Bond '96 assuring a fixed monthly income for 10 years after the expiry of the wait period. This bond can be gifted to any person.

(xix) Regular Income Bond : This bond offers an attractive rate of interest payable half yearly with the facility of early redemption. The investor is assured of regular and fixed income. For example, the IDBI has issued Regular Income Bond '96 carrying 16% interest p.a. It is redeemable at the end of every year from the expiry of 3 years from the date of allotment.

(xx) Infrastructure Bond : It is a kind of debt instrument issued with a view to giving tax shelter to investors. The resources raised through this bond will be used for promoting investment in the field of certain infrastructure industries. Tax concessions are available under Sec.88, Sec.54 EA and Sec.54EB of the Income Tax Act. HUDCO has issued for the first time such bonds. Its face value is

Rs.1000 each carrying an interest rate of 15% per annum payable semi annually. This bond will also be listed in important stock exchanges.

(xxi) Carrot and Stick bonds : Carrot bonds have a low conversion premium to encourage early conversion, and sticks allow the issuer to call the bond at a specified premium if the common stock is trading at a specified percentage above the strike price.

(xxii) Convertible Bonds with a Premium put : These are bonds issued at face value with a put, which means that the bond holder can redeem the bonds for more than their face value.

(xxiii) Debt with Equity Warrant : Sometimes bonds are issued with warrants for the purchase of shares. These warrants are separately tradable.

(xxiv) Dual Currency Bonds : Bonds that are denominated and pay interest in one currency and are redeemable in another currency come under this category. They facilitate interest rate arbitrage between two markets.

(xxv) ECU Bonds (European Currency Unit Bonds) : These bonds are denominated in a basket of currencies of the 10 countries that constitute the European community. They pay principal and interest in ECUs or in any of the 10 currencies at the option of the holder.

(xxvi) Yankee Bonds : If bonds are raised in U.S.A., they are called Yankee bonds and if they are raised in Japan, they are called Samurai Bonds.

(xxvii) Flip-Flop Notes : It is a kind of debt instrument which permits investors to switch between two types of securities e.g. to switch over from a long term bond to a short term fixed-rate note.

(xxviii) Floating Rate Notes (FRNs) : These are debt instruments which facilitate periodic interest rate adjustments.

(xxix) Loyalty Coupons : These are entitlements to the holder of debt for two to three years to exchange into equity shares at discount prices. To get this facility, the original subscriber must hold the debt instruments for the said period.

(xxx) Global Depository Receipt (GDR) : A global depository receipt is a dollar denominated instrument traded on a stock exchange in Europe or the U.S.A./ or both. It represents a certain number of underlying equity shares. Though the GDR is quoted and traded in dollar terms, the underlying equity shares are denominated in rupees. The shares are issued by the company to an intermediary called depository in whose name the shares are registered. It is the depository which subsequently issues the GDRs.

2.8 CHALLENGES FACING THE FINANCIAL SERVICES SECTOR

However, the financial service sector has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy. Some of the important challenges are reported hereunder :

(i) Lack of qualified personnel : The financial services sector is fully geared to the task of 'financial creativity'. However, this sector has to face many challenges. In fact, the dearth of qualified and trained personnel is an important impediment in its growth. Hence, it is very vital that a proper and comprehensive training must be given to the various financial intermediaries.

(ii) Lack of investor awareness : The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments. Hence, the financial intermediaries should educate the prospective investors/users of the advantages of the innovative instruments through literature, seminars, workshops, advertisements and even through audio-visual aids.

(iii) Lack of transparency : The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global

environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner. Hence, this sector should opt for better levels of transparency. In other words, the disclosure requirements and the accounting practices have to be in line with the international standards.

(iv) Lack of specialization : In the Indian scene, each financial intermediary seems to deal in different financial service lines without specializing in one or two areas. In other words, each intermediary is acting as a financial super market delivering so many financial products and dealing in different varieties of instruments. In other countries, financial intermediaries like Newtons, Solomon Brothers etc. specialize in one or two areas only. This helps them to achieve high levels of efficiency and excellence. Hence, in India also, financial intermediaries can go for specialization.

(v) Lack of recent data : Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon 'financial creativity'. Moreover, a proper data base would keep oneself abreast of the recent developments in other parts of the whole world and above all, it would enable the fund managers to take sound financial decisions.

(vi) Lack of efficient risk management system : With the opening of the economy to multinationals and the exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk. Unless a proper risk management system is developed by the financial intermediaries as in the West, they would not be in a position to fulfil the growing requirements of their customers. Hence, it is absolutely essential that they should introduce Futures, Options, Swaps and other derivative products which are necessary for an efficient risk management system.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the

occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

2.9 PRESENT SCENARIO

The present scenario of financial service sector is :

(i) Conservatism to dynamism

At present, the financial system in India is in a process of rapid transformation, particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. As a result, we have recently witnessed phenomenal changes in the money market, securities market, capital market, debt market and the foreign exchange market. In this changed context, the role of financial services has assumed greater significance in our county. At present, numerous new financial intermediaries have started functioning with a view to extending multifarious services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies have transformed the financial services sector from being a conservative industry to a very dynamic one.

(ii) Emergence of Primary Equity Market

Now, we are also witnessing the emergence of many private sector financial services. The capital markets which were very sluggish, have become a popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 24 in 2004. The aggregate funds raised by the industries in the primary markets have gone from up. The number of companies listed on the stock exchange have also gone up from 2265 in 1980 to over 10000 in 2004. Thus,

the primary equity market has emerged as an important vehicle to channelise the savings of the individuals and corporates for productive purposes and thus to promote the industrial and economic growth of our nation.

(iii) Concept of Credit Rating

There is every possibility of introducing equity grading. Hitherto, the investment decisions of the investors have been based on factors like name recognition of the company, operations of the group, market sentiments, reputation of the promoters etc. Now, grading from an independent agency would help the investor in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company point of view, equity grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Thus, grading would give further fillip to the primary market. Moreover, the concept of credit rating would play a significant role in identifying the risk level of the corporate entity in which the investor wants to take part.

Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments. The three major credit rating agencies functioning in India are:

(i) Credit Rating Information Services of India Ltd. (CRISIL)

(ii) Credit Analysis and Research ltd. (CARE) and

(iii) Investment Information and Credit Rating Agency (ICRA)

(iv) Duff Phelps Credit Rating Pvt. Ltd. (DCR India)

Their activities have been mainly confined to debt instruments only.

(iv) Process of Globalisation

Again, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Since the Government is

very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentiabilities for the introduction of innovative international financial products in India are very great. Moreover, India is likely to enter the full convertibility era soon. Hence, there is every possibility of introduction of more and more innovative and sophisticated financial services in our country.

(v) Process of Liberalisation

Realizing all these factors, the Government of India has initiated many steps to reform the financial services industry. The Government has already switched over to free pricing of issues from pricing issues. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. The Securities Exchange Board of India has liberalized many stringent conditions so as to boost the capital and money markets. In this changed context, the financial service industry in India has to play a very position and dynamic role in the years to come by offering many innovative products to suit to the varied requirements of the millions of prospective investors spread throughout the country.

2.10 SUMMARY

Financial services constitute an important component of the financial system. Financial services serve the needs of individuals, institutions and corporate through a network of elements. Prior to economic liberalization, the Indian Financial Service Sector was charaterised by so many factors which retarded its growth. Financial services covers a wide range of activities and they can be broadly classified into traditional activities and modern activities. In the changed economic scenario, many financial intermediaries have started expanding their activities in the financial services sector by offering a variety of new products. The financial service sector has thus emerged as the fastest growing sunrise industry. However, the financial service sector has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy.

2.11 KEYWORDS

Financial Service: Financial services comprise of various functions and services that are provided by financial institutions in financial system.

Securitisation: It is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable.

Treasury Bill: A treasury bill is a money market instrument issued by the Central Government.

Convertible Bond: A convertible bond is one which can be converted into equity shares at a pre-determined timing either fully or partially.

2.12 SELF ASSESSMENT QUESTIONS

1. Define a financial service industry and discuss the various services rendered by it.
2. “Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy”. Discuss.
3. Discuss some of the innovative financial instruments introduced in recent times in the financial service sector.
4. Critically analyze the present position of the financial service sector in India and state the challenges it has to face in the years to come.

2.13 SUGGESTED READINGS

Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

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Chandra, P., Financial Management, Tata McGraw Hill, New Delhi.

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Course Code	**:**	**FM-404**		
Subject	**:**	**Management of Financial Services**		

LESSON-3
INSURANCE

STRUCTURE

3.O Objective
3.1 Introduction
3.2 Nature or Characteristics of Insurance
3.3 Functions of Insurance
3.4 Pre-requisites for the Success of Insurance
3.5 Limitations of Insurance
3.6 Scope or Classification of Insurance
3.7 Principles of Insurance
3.8 Summary
3.9 Keywords
3.10 Self Assessment Questions
3.11 Suggested Readings

3.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define insurance and explain its features and functions.

(b) Discuss the classification of insurance.

(c) Describe the principles of insurance.

3.1 INTRODUCTION

Insurance may be described as a social device to reduce or eliminate risks of loss to life and property. It is a provision which a prudent man makes against inevitable contingencies, loss or misfortune.

Once Frank H. Knight said “Risk is uncertainty and uncertainty is one of the fundamental facts of life.” Insurance is the modern method by which men make the uncertain, certain and the unequal, equal. It is the means by which success to the support of the weak and weak secure, not by favour sent by right duly purchased and paid for, the support of the strong.

Under the plan of insurance, a large number of people associate themselves by sharing risks attached to individuals. As in private life, in business also there are dangers and risks of different kinds. The aim of all types of insurance is to make provision against such dangers. The risks which can be insured against include fire, the perils of sea (marine insurance), death (life insurance) and, accidents and burglary. Any risk contingent upon these, may be insured against at a premium a commensurate with the risk involved. Thus, collective bearing of risks is insurance.

The term ‘insurance’ has been defined by different experts on the subject as follows :

In the words of John Magee, “Insurance is a plan by which large number of people associate themselves and transfer to the shoulders of all, risks that attach to individuals.”

In the words of Allen Z. Mayerson, “Insurance is a device for the transfer to an insurer of certain risks of economic loss that would otherwise come by the insured.”

In the words of Justice Channel, “ Insurance is a contract whereby one person, called the insurer, undertakes in return for the agreed consideration called premium, to pay to another person called the insured, a sum of money or its equivalent on specified event.”

3.2 NATURE OR CHARACTERISTICS OF INSURANCE

The following are the characteristics of insurance :

1. Sharing of risks : Insurance is a cooperative device to share the burden of risk which may fall on happening of some unforeseen events, such as the death of head of the family, or on happening or marine perils or loss of by fire.

2. Cooperative device : Insurance is a cooperative form of distributing a certain risk over a group of persons who are exposed to it. A large number of persons share the losses arising from a particular risk.

3. Evaluation of risk : For the purpose of ascertaining the insurance premium, the volume of risk is evaluated, which forms the basis of insurance contract.

4. Payment on happening of specified event : On happening of specified event, the insurance company is bound to make payment to the insured. Happening of the specified event is certain in life insurance; but in the case of fire, marine or accidental insurance, it is not necessary. In such cases, the insurer is not liable for payment of indemnity.

5. Amount of Payment : The amount of payment in indemnity insurance depends on the nature of losses occurred, subject to a maximum of the sum insured. In life insurance, however, a fixed amount is paid on the happening of some uncertain event or on the maturity of the policy.

6. Large number of insured person : The success of insurance business depends on the large number of persons insured against similar risk. This will enable the insurer to spread the losses of risk among large number of persons, thus keeping the premium rate at the minimum.

7. Insurance is not a gambling : Insurance is not a gambling. Gambling is illegal which gives gain to one party and loss to the other. Insurance is a valid contract to indemnity against losses. Moreover, insurable interest is present in insurance contracts and it has the element of investment also.

8. Insurance is not charity : Charity pays without consideration but in the case of insurance, premium is paid by the insured to the insurer in consideration of future payment.

9. Protection against risks : Insurance provides protection against risks involved in life, materials and property. It is a device to avoid or reduce risks.

10. Spreading of risks : Insurance is a plan which spreads the risks and losses of few people among a large number of people. John Magee writes, “Insurance is a plan by which a large number of people associate themselves and transfer to the shoulders of all, risks attached to individuals”.

11. Transfer of risk : Insurance is a plan in which the insured transfers his risk on the insurer. this may be the reason that Mayerson observes, that insurance is a device ot transfer some economic losses to the insurer, otherwise such losses would have been borne by the insureds themselves.

12. Ascertaining of losses : By taking a life insurance policy, one can ascertain his future losses in terms of money. This is done by the insurer to determining the rate of premium; which is calculated on the basis of maximum risks.

13. A contract : Insurance is a legal contract between the insurer and insured under which the insurer promises to compensate the insured financially within the scope of insurance policy, and the insured promises to pay a fixed rate of premium to the insurer.

14. Based upon certain principle : Insurance is a contract based upon certain fundamental principles of insurance which includes, utmost good faith, insurable interest, contribution, indemnity, causa proxima, subrogation, etc. which are the basis for successful operation of insurance plan.

15. Institutional set up : After nationalization, the insurance business in the country is operating under statutory organizational set up. In India, the Life Insurance Corporation, the General Insurance Corporation and its subsidiary companies, and private players are operating in the various fields of insurance.

16. Insurance for pure risks only : Pure risks give only losses to the insured, and no profits. Examples of pure risks are – accident, misfortune, death, fire, injury etc. which are all one-sided risks and the ultimate result in loss. Insurance companies issue policies against pure risks only, not against speculative risks. Speculative risks have chances of profits of losses.

17. Social device : Insurance is a plan of social welfare and protection of interests of the people and Miller observe, "Insurance is of social nature."

18. Based on mutual good-faith : Insurance is a contract based on good faith between the parties. Therefore, both the parties are bound to disclose the important facts affecting to the contract before each other. Utmost good faith is one of the important principles of insurance.

19. Regulation under the law : The government of every country enacts the law governing insurance business so as to regulate and control its activities for the interest of the people. In India the Life Insurance Act 1956 and General Insurance (Nationalisation) Act 1972 and Insurance Regulatory and Development Authority Act 1999 are the major enactments in this direction.

20. Wider scope : The scope of insurance is much wider and extensive. Various types of policies have been developed in the country against risks on life, fire, marine, accident, theft, burglary etc.

To conclude, insurance is a device for the transfer of risks from the insureds to insurers, who agree to it for a consideration (known as premium), and promises that the specified extent of loss suffered by the insureds shall be compensated. It is a legal contract of a technical nature.

3.3 FUNCTIONS OF INSURANCE

The functions of insurance may be categorized as below :

I. Primary Functions

II. Secondary Functions

III. Other Functions

I. Primary Functions

The primary functions of insurance include the following :

1. Provide protection : The primary purpose of insurance is to provide protection against future risk, accidents, and uncertainty. Insurance cannot check the happending of the risk, but can certainly provide for the losses of risk. Professor Hopkins observes, “Insurance is a protection against economic loss by sharing the risk with others.” He further add “Insurance is the protection against economic loss.”

2. Collective bearing of risk : Insurance is a device to share the financial loss of few among many others. Dinsdale opines, insurance is a mean by which few losses are shares among longer people. Similarly, William Bevridge observes, “The collective bearing of risks is insurance.” All the insureds contribute the premiums towards a fund and out of which the persons exposed to a particular risk is paid. Similarly, Rigel and Miller observe, “Insurance is a device whereby the uncertain risk may be made more certain.”

3. Evaluation of risk : Insurance determines the probable volume of risk by evaluating various factors that give rise to risk. Risk is the basis for determining the premium rate also.

4. Provide certainty against risk : Insurance is a device which helps to change from uncertainty to certainty. This may the reason that John Magee writes that the function of insurance is to provide certainty. Similarly, Riegel and Miller observe, “The function of insurance is primarily to decrease the uncertainty of events.”

5. Spreading risks : Professor Thomas has correctly written that “Insurance is the device for spreading or distributing risks.”

II. Secondary Functions

1. **Prevention of losses :** Insurance cautions individuals and businessmen to adopt suitable device to prevent unfortunate consequences of risk by observing safety instructions; installation of automatic sparkler or alarm systems, etc. Prevention of losses cause lesser payment to the assured by the insurer and this will encourage for more savings by way of premium. Reduced rate of premiums stimulate for more business and better protection to the insureds. The Loss Prevention Association of India formed by the insurers, alerts the people about future risks and uncertainties through publicity measures.

2. **Small capital to cover larger risks :** Dinsdale observes, insurance relives the businessmen and others from security investments, by paying small amount of premium against larger risk and uncertainty. There is no need for them to invest separately for security purpose and this money can be invested in other activities.

3. **Contributes towards the development of larger enterprises :** Insurance provides development opportunity to those larger enterprises having more risks in their setting up. Even the financial institutions may be prepared to give credit to sick industrial units which have insured their assets including plant and machinery.

III. Other Functions

There are indirect functions of insurance which benefit the economy indirectly. Some of such functions are :

1. **Means of savings and investment :** Insurance serves as savings and investment. Insurance is a compulsory way of savings and it restricts the unnecessary expenses by the insureds. For the purpose of availing income-tax exemptions also, people invest in insurance. In the words of Magee “Although investment is not the primary function of insurance. Investment service is proved to be an important benefit of insurance.

2. **Source of earning foreign exchange :** Insurance is an international business. The country can earn foreign exchange by way of issue of marine insurance policies.

3. **Promotes exports :** Insurance makes the foreign trade risk free through different types of policies issued under marine insurance cover. In case of loss of cargo and others due to marine perils the insurance company makes good the loss.

4. **Provides social security :** Through various social protection plans, the insurance provides social security to people. It not only provide security at the time of death but also provides assistance to the insureds at the time of sickness, old age, maternity etc.

3.4 PRE-REQUISITES FOR THE SUCCESS OF INSURANCE

For the successful operations of insurance, certain important factors or requisites are very essential. These are :

1. Presence of a large number of risks.
2. More risks in the life or property of a person so that he may feel necessary to be insured.
3. Probability of real loss on account of risk.
4. Presence of a large umber of people exposed with the same nature and kind of risks.
5. Involvement of loss from the risk must be large enough.
6. The loss from the expected risk should be determinable in advance.
7. The happening of loss/event must be beyond the control of the insured.
8. The loss to all the insureds should not take place at a time. Otherwise, the insurer may face problem in discharging all the claims at a time.
9. The cost of insurance should be feasible. In other words, the premium rates should be reasonable so that large number of people can opt for insurance as a device against risk.

10. The risk insurable should be such to become easier to calculate the actual loss.

3.5 LIMITATIONS OF INSURANCE

In spite of number of advantages of insurance, it has certain limitations. On account of such limitations, the benefits of insurance could not be availed in full. These limitations are :

1. **All the risk cannot be insured :** All the risk cannot be insured; only pure risks can be insured, and speculative risks re not insurable.

2. **Insurable interest (financial interest) on the subject matter :** Insurance is possible only when the insured has insurable interest in the subject matter of insurance either at the time of insurance or at the time of loss, or at both the times; in the absence of which the contract of insurance becomes void.

3. **Impossibility of measurement of real loss :** In case the loss arisen from the happening of the event cannot be valued in terms of money, such risks are not insurable.

4. **Not possible to insure the risk covered by a single individual or a small group:** Insurance against the risk of a single individual or a small group of persons are not advisable since it is not practicable due to higher cost involved.

5. **Higher premium rates :** Another important limitation is that the premium rates are higher in our country and as such, certain category of people cannot avail the advantage of insurance. The main reason for the higher rate of premiums is the higher operating cost.

6. **Moral hazards :** It becomes difficult to control moral hazards in insurance. There are certain people who misutilize the insurance plans for their self-interest by claiming false claims from insurance companies.

7. **Certain rights cannot be insured by private insurers :** The private insurers are not permitted to insure certain specified types of risks like unemployment insurance, bankruptcy of banks insurance, etc.

8. **Unattractive investment :** Insurance is not a profitable investment. Its main object is to provide security against risks. Insurance business cannot be a source to acquire profits.

9. **In certain cases cooperation of government is necessary :** Certain specified risks can be insured with cooperation of the government only; such as unemployment insurance, insolvency of banks, food insurance, etc.

10. **All the pure risks are not insured :** All the pure risks are not insured by the insurer. Even if does with higher rate of premium only. For example, insurer does not take any interest to accept a proposal of a person whose heart surgery has gone through.

3.6 SCOPE OR CLASSIFICATION OF INSURANCE

Broadly, insurance may be classified into the following categories :

I. Classification on the basis of nature of business

II. Classification from business point of view

III. Classification from risk point of view

I. On the basis of nature of business

On the basis of nature of business, insurance may be the following types :

1. Life Insurance
2. Fire Insurance
3. Marine Insurance
4. Social Insurance, and
5. Miscellaneous Insurance

1. Life Insurance : Life insurance may be defined as a contract in which the insurer, in consideration of a certain premium, either in a lump sum or by other periodical payments, agrees to pay the assured, or to the person for whose benefit the policy is taken, the assured sum of money, on the happening of a specified event contingent on the human life.

A contract of life insurance, as in other forms of insurance, requires that the assured must have at the time of the contract an insurable interest in his life upon which the insurance is affected. In a contract of life insurance, unlike other insurance, interest has only to be proved at the date of the contract, and not necessarily present at the time when the policy falls due.

A person can assure in his own life and every part of it, and can insure for any sum whatsoever, as he likes. Similarly, a wife has an insurable interest in her husband and vice-versa. However, mere natural love and affection is not sufficient to constitute an insurable interest. It must be shown that the person affecting an assurance on the life of another is so related to that other person as to have a claim for support. For example, a sister has an insurable interest in the life of a brother who supports her.

A person not related to the other can have insurable interest on that other person. For example, a creditor has insurable interest in the life of his debtor to the extent of the debt. A creditor can insure the life of his debtor upto the amount of the debt, at the time of issue of the policy.

An employee has an insurable interest in the life of the employer arising out of contractual obligation to employ him for a stipulated period at fixed salary. Similarly, from an employer to the employee, who is bound by the contract to serve for a certain period of time.

2. Fire Insurance : A fire insurance is a contract to indemnity the insured for distribution of or damage to property caused by fire. The insurer undertakes to pay the amount of the insureds loss subject to the maximum amount stated in the policy. Fire

insurance is essentially a contract of indemnity, not against accident, but against loss caused by accident. It is becoming very common in fire insurance policies to insert a condition, called the average clause, by which the insured is called upon to bear a portion of the loss himself. The main object of this clause is to check under-insurance and to encourages for full insurance. It impress upon the property-owner for the need of having his property accurately valued before insurance.

Regarding insurable interest, the insured must have insurable interest in the subject matter both at the time of affecting the policy and at the time of loss. The risk in fire insurance policy commences from the moment of cover note, or the deposit receipt, or the interim protection is issued, and continues for the term covered by the contract of insurance. It may even date back; if the parties so intend. The rate of premium varies to the degree of hazard or risk involved.

3. Marine Insurance : A contract of marine insurance is an agreement whereby the insurer undertakes to indemnity the assured in a manner and to the extent thereby agreed, against marine losses, that is, the losses incidental to marine adventure. There is a marine adventure when any insurable property is exposed to marine perils. Marine perils also known as perils of the seas, means the perils consequent on, or incidental to, the navigation of the sea or the perils of the seas, such as fire, war perils, pirates, robbers, thieves; captures, jettisons, barratry and any other perils which are either of the like kind or may be designed by the policy.

There are different types of marine policies known by different names according to the manner of their execution or the risk they cover. They are : voyage policy, time policy, valued policy, unvalued policy, floating policy, wager or honour policy.

4. Social Insurance : Social insurance has been developed to provide economic security to weaker sections of the society who are unable to pay the premium for adequate insurance. The following types of insurance can be included in social insurance:

(i) **Sickness Insurance :** In this type of insurance medical benefits, medicines and reimbursement of pay during the sickness period, etc. are given to the insured person who fell sick.

ii) **Death Insurance :** Economic assistance is provided to dependants of the assured in case of death during employment. The employer can transfer his such liability by getting insurance policy against employees.

iii) **Disability Insurance :** There is provision for compensation in case of total or partial disability suffered by factory employees due to accident while working in factories. According to Employees Compensation Act, the responsibility to pay compensation is vest with the employer. But the employer transfers his liability on the insurer by taking group insurance policy.

iv) **Unemployment Insurance :** In case insured person becomes unemployed due certain specific reasons, he is given economic support till he gets employment.

v) **Old-age Insurance :** In this category of insurance, the insured or his dependents is paid, after certain age, economic assistance.

For the last few years, the Indian Government has extended the scope of Social Insurance. Under the concept of social justice, this scheme now extended to Daily-wages earners, Rickshaw pullers, Landless labourers, Sweepers, Craftsmen, etc. through different insurance plans.

5. Miscellaneous Insurance : The process of fast development in the society gave rise to a number of risk or hazards. To provide security against such hazards, many other types of insurance also have been developed. The important among them are :

(i) Vehicle insurance on buses, cars, trucks, motorcycles, etc. and made compulsory so that the losses due to accidents can be claimed from the insurance company.

(ii) Personal accident insurance by paying an annual premium Rs.12 on policy worth Rs.12,000. In case of accidental death or total/partial disability, a fixed amount as per conditions of insurance, is paid to the insured.

(iii) Burglary insurance -- (against theft, decoity etc.)

(iv) Legal liability insurance (insurance whereby the assured is liable to pay the damages to property or to compensate the loss of personal injury or death. This is in the form of fidelity guarantee insurance, automobiles insurance and machines etc.)

(v) Crop insurance (crops are insured against losses due to heavy rains and floods, cyclone, draughts, crop diseases, etc.)

(vi) Cattle insurance (Insurance for indemnity against the loss of cattle from various kinds of diseases).

In addition to the above, insurance plans are available against crime, medical insurance, bullock cart, jewellery, cycle rickshaw, radio, T.Vs., etc.

II. Classification from business point of view

From business point of view, insurance can be classified into two broad categories:

1. Life Insurance; and
2. General Insurance

1. Life Insurance : According to Life Insurance Act, 1938, life insurance refers to the contract of insurance on human life, under which if any individual's death, other than accident, or happening of any event concerning to human life, a certain amount is guaranteed to be paid to assured or his/her legal representative. According to the terms of contract the assured should pay premium, the rate of which may differ according to the human life. The act also provides for :

(a) Payment of double or triple rate of accidental benefits, as per terms of contract.

(b) Annuity on human life, and

(c) Superannuation allowance and annuity from the funds created for granting assistance to such persons.

2. General Insurance : General insurance business refers to fire, marine, and miscellaneous insurance business whether carried on singly or in combination with one or more of them, but does not include capital redemption business and annuity certain business. (According to Sec.3(g) of the General Insurance Business (Nationalisation) Act, 1972).

III. Classification from Risk Point of View

From risk point of view, insurance can be classified into four categories :

1. Personal Insurance
2. Property Insurance
3. Liability Insurance
4. Fidelity Guarantee Insurance

A brief description of each is given below :

1. Personal Insurance : Personal insurance refers, the loss of life by accident, or sickness to individual which is covered by the policy. The insurer undertakes to pay the sum insured on the happening of certain event or on maturity of the period of insurance. This insurable sum is determined at the time of affecting the policy and include life insurance, accident insurance, and sickness insurance. Life insurance contains the element of investment and protection, while the accidental, sickness or health insurance contain the element of indemnity only.

2. Property Insurance : Contract of property insurance is a contract of indemnity. Proof by the assured of loss is an essential element of property insurance. The

policies of insurance against burglary, home-breaking or theft etc. fall under this category. The assured is required to protect the insured property. After the loss has taken place, the assured usually required to notify the police as to losses.

3. **Liability Insurance :** Liability insurance is the major field of general insurance whereby the insurer promises to pay the damage of property or to compensate the losses to a third party. The amount of compensation is paid directly to third party. The fields of liability insurance include workmen compensation insurance, third party motor insurance, professional indemnity insurance and third party liability insurance etc. In liability insurance, there may be various reasons for the arising of liability; viz. accident to a worker at the workplace, defective goods, explosion in the factory during the process of production, formation of poisonous gas within the factory, due to the uses of chemicals and other such substances in the manufacturing process.

4. **Fidelity Guarantee Insurance :** In this type of insurance, the insurer undertakes to indemnify the assured (employer) in consideration of certain premium, for losses arising out of fraud, or embezzlement on the part of the employees. This kind of insurance is frequently adopted as a precautionary measure in cases where new and untrained employees are given positions of trust and confidence.

3.7 PRINCIPLES OF INSURANCE

A contract of insurance like any other contract must possess all the essential elements of a contract, e.g. existence of an agreement, free consent of parties, competence of parties to enter into an agreement, lawful consideration, etc. In addition to these, the following requirements (principles) are most essential for a contract of insurance to be valid :

1. **Good Faith :** The legal maxim caveat emptor (let the buyer beware) prevails in ordinary business contracts. However, the insurance contracts are an exception to the said principle of caveat emptor.

A contract of insurance is a contract uberimae fidei (i.e. based on absolute good faith). It means that the insured must disclose all material facts concerning the subject matter of the insurance. If a material fact is not disclosed or if there is misrepresentation or fraud, it shall render the contract voidable at the option of the insurer. What is a material fact depends on the circumstances of each individual case. Hence it is a question of fact and not a question of law. It is for the law court to decide whether there has or has not been a failure to disclose material facts. Generally speaking, a material fact is one which the insurer shall take into account while considering whether to accept the risk or not to accept the risk. Further the fact is also material if it has a bearing on the amount of premium which the insurer will charge. It is important to remember that the onus of proof of concealment lies on the insurer. Further, the doctrine of good faith is not one-sided. Like the insured, the insurer is duty bound to disclose such material facts as are within his knowledge or that of his agents. For example, he must draw attention to any restrictions in his policy.

2. Indemnity : Life insurance is a contingent contract, i.e. the money becomes payable on the happening of an agreed event, e.g. in endowment policy the agreed sum becomes payable after a certain specified period of time or death whichever is earlier. Hence, the agreed sum becomes payable sooner or later.

Other forms of insurance (e.g. fire or marine) are not contingent contracts. They are contracts of indemnity. The insurer in these cases promises to indemnify the insured person for what he actually losses on account of some mischance or misfortune. “The contract of insurance contained in a marine or fire policy is a contract of indemnity and of indemnity only, and that this contract means that the assured, in case of a loss against which the policy has been made, shall be fully indemnified but shall never be more than fully indemnified”.

The considerations of public interest also dictate that the insured must not get anything more than the actual loss since otherwise the assured may be under constant temptation to destroy his property and commit a certain social act. Even in case of over-

insurance (i.e. where policy is taken for a sum more than the real value of the property), the assured is entitled to only actual loss.

3. Subrogation : According to the principle of subrogation, the insurer becomes entitled to all the rights of the ensured as regards the subject matter of insurance. The principle has been expressed in an American case in the following words :

> "Subrogation is the substitution of one person in place of another, whether as a creditor or as the possessor of any other rightful claim, so that he who is substituted succeeds to the rights of the other in relation to the claim, its rights remedies, or securities".

The insured may have the rights against the third party on account of negligence of the third party or on account of some mischief of the third party or on account of an agreement between the insured or third party etc.

The following essential characteristics of the doctrine of subrogation deserve consideration :

(a) Contracts of Life and Personal Accident Insurance : The doctrine of subrogation applies only to contracts of indemnity (i.e. contracts of fire and marine insurance) since the principle is in itself a mere corollary of the 'doctrine of indemnity'. It does not apply to contracts of life and personal accident insurance. Hence, the legal representative can get the insured sum from the insurance as well as the damages, if any, from the third party.

(b) Payment of the whole loss : The 'doctrine of subrogation' applies only upon payment of the whole loss by the insurer to the insured. In case of partial loss, the principle does not apply. However, the express provision may entitle the insurer to exercise his right of subrogation even before the payment has been made to the insured.

(c) The insured to surrender all his rights claims and remedies in favour of insurers : Upon payment of the whole loss by insurers to the insured, the insurers

shall step into the shoes of the insured and shall avail themselves of all the rights-claims and remedies which the insured had against the third party/parties. If the insured himself receives compensation for the loss from the third party after he has been indemnified by his insurer, he holds that further compensation as a trustee for his insurer, to the extent that the latter is entitled to.

(d) **Insurer entitled to benefit only to the extent of his payment :** The insurer is, by virtue of subrogation, entitled to rights, claims and remedies only to the extent of his payment. It has been made quite clear in a U.S. case according to which if the insurer, upon payment of the claim to the insured, recovers from the defaulting third party more than the amount paid under the policy, he has to pay this excess to the insured, though he may charge the insured his share of reasonable expenses incurred in collecting the money.

(e) **The insured to provide facility to the insurer :** Any action taken by the insurer against the third party is usually in the name of the assured. However, the cost of any action taken is borne by the insurer. The insured is duty bound to give to the insurer all such reasonable facilities as the latter may require in enforcing his rights against the third parties.

(f) **The insurer entitled to only such rights as are available to the insured :** The insurer shall be entitled to only such rights as are available to the insured. He cannot acquire better rights against the parties at fault than what the insurer himself would have had.

4. **Insurable Interest :** The assured must possess an ‘insurable interest’ in the subject matter of insurance. For an insurance contract to be valid, ‘Insurable Interest’ is the legal right to insure. The legal right to insure is measured in terms of money and vests in a person to whom the law recognizes as a person who is interested in the preservation of a thing or the continuance of a life. Mere mutual love and affection is not considered in law as sufficient to an insurable interest for purposes of obtaining an insurance cover. A

contract of insurance without an insurable interest is a wagering agreement and is void. 'Insurable interest' in different types of insurances is discussed below.

Some of the instances where a person has an insurable interest in the life of another are as follows :

1. A son may insure his father's life on whom he is dependent. Similarly, the father can take an insurance policy on his son's life when he is dependent on him. The sum recoverable under a life policy is limited to the amount or value of the insured's insurable interest in the life insured at the date of the policy.
2. A creditor can take an insurance on the life of his debtor only upto the amount of his debt plus some additional charges on account of premiums and interest.
3. A partner can insure the life of another partner to the extent of the latter's capital only. It is because in the event of his death, it is only his share in the business that needs to be paid out for running the business smoothly as far as money is concerned even after his death.
4. An employer has also an insurable interest in the life of his contractor, a corporation has an insurable interest in the life of a senior officer during the course of his employment in the company whose death might adversely affect the profits of the business.
5. A trustee has an insurable interest with regard to interest of which he is a trustee.
6. An insurer has an insurable interest in the subject matter of a policy, therefore, he can get re-insurable cover.
7. Surety in the life of his principal debtors to the extent of his guarantee only.

5. Cause Proxima : *Causa proxima* is a Latin phrase which means proximate cause (i.e. nearest cause). It means that when the loss arises on account of more than one cause,

then the nearest cause is considered responsible for the loss. It is that cause which, in a natural and unbroken series of events, is responsible for loss or damage. It is the cause closest to the result in order of effect, though not necessarily in time. Thus such a cause is proximate in efficiency. The principle of causa proxima states that to ascertain whether the insurer is liable for the loss or not, the proximate and not the remote cause must be looked to.

If there is only one cause of damage or loss, there is no difficulty in fixing the liability of the insurer. However, usually the loss or damage arises on account of a series of causes. In such a case, the principle of causa proxima is applied. But too much stress must not be laid on the word 'proximate' in the sense as to lose sight or destroy altogether the idea of the cause itself. The true and over-ruling principle is to look at the contract as a whole and to ascertain what the parties to it really want, what was that which brought about the loss, the event the accident, and this is not in an artificial sense, but in the real sense which the parties to a contract have in mind, when they speak of cause at all.

6. Doctrine of Contribution : It is another corollary of the Doctrine of Indemnity. The insured can realize his loss from the insurance companies, in case he is having more than one policy on the same subject matter which has been destroyed, in any order he likes. Of course, he is not permitted to recover more than the actual loss. The recovery of loss by the insured according to his discretion usually creates inequities among different insurers. The doctrine of contribution ensures equitable distribution of loss as between insurers. The doctrine of contribution states that insurer/insurers who has/have paid more than his/their proportionate share to the insured shall have the right to recover the proportionate contribution from other insurer/insurers. For example, a person insures his house under two policies--with A for Rs.20,000 and with B for Rs.8,000. Now suppose the loss if for Rs.18,000, the contribution shall be as follows :

A shall pay $\frac{20,000}{\text{----------}} \times 18,000 = \text{Rs. } 12857.00$

28,000

B shall pay 8,000

--------- X 18,000 = Rs. 5,143.00

28,000

The above discussion reveals the following characteristics of the doctrine of contribution :

(1) The subject-matter of insurance must be same to all the policies;

(2) The peril which is insured against must be the same in all the policies;

(3) The same insured must be there in all the policies; and

(4) All the policies must be in force when the loss occurs.

It may, however, be stated that the contribution clause is usually there in the policy. This clause limits liability of the insurance company to its retable proportion of the loss due to insured peril if there is any other insurance effected by or on behalf of the insured covering any of the property destroyed or damaged. This clause discourages multiple or over-insurance and thereby prevents unfair methods of competition. The doctrine of contribution like the principles of subrogation and indemnity is applicable to fire and marine policies only.

3.8 SUMMARY

A contract of compensation for the loss or damage suffered on the occurrence of certain specified events by the insured is called insurance. Premium is payable for the period of insurance. An insurance contract is built on certain principles, such as good faith, insurable interest, compensation, subrogation, contribution etc. A life insurance contract serves the purpose of protection as well as an investment contract. It is a protection contract since it gives protection to the assured in the event of death by making a payment of the entire amount of sum assured. It is an investment contract too, as it gives the assured the advantage of returning the money with interest and bonus at the end of the policy. A contract of general insurance serves only as a protection contract and not as an investment contract, where the money paid as premium will come back to the insured, by way of claims, only on the occurrence of some

specified events.

3.9 KEYWORDS

Insurance: A contract whereby one party undertakes to compensate the other party for any loss or damage suffered by the latter, in consideration of payment of premium for a certain period of time is known as insurance.

Life Insurance: A contract in which the insurer undertakes to pay a certain sum of money to the insured, either on the expiry of a specified period, or on the death of the insured, in consideration of payment of premium for a certain period of time is known as life insurance.

General Insurance: A contract whereby upon periodic payment of a sum of money called premium the insurer undertakes to compensate the insured in the event of any specified loss or loss suffered by the latter, is known as general insurance.

Fire Insurance: Under fire insurance, the insurance company undertakes to indemnify the loss sustained by the insured party on account of fire accident.

Marine Insurance: An insurance contract which covers the risks of loss arising from the incidental to marine adventure is known as marine insurance.

3.10 SELF ASSESSMENT QUESTIONS

1. “Insurance is a process in which uncertainties are made certain.” Discuss the statement and explain the importance of insurance.
2. Define insurance and describe its main characteristics.
3. Describe the various kinds of insurance.
4. “A contract of insurance is a contract of utmost good faith.” Discuss.
5. Define insurable interest. Discuss the importance of this principle.

3.11 SUGGESTED READINGS

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Course Code	**:**	**FM-404**	
Subject	**:**	**Management of Financial Services**	

LESSON-4
INTRODUCTION TO BANKING

STRUCTURE

4.0 Objective
4.1 Introduction
4.2 Meaning and Definition of a Bank
4.3 Types of Banks
4.4 Functions of Commercial Banks
4.5 Summary
4.6 Keywords
4.7 Self Assessment Questions
4.8 Suggested Readings

4.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define the bank and explain various types of banks.

(b) Discuss the functions of commercial banks.

4.1 INTRODUCTION

As for as the origin of the present banking system in the world is concerned, the first bank called the “Bank of Venice” is believed to be established in Italy in the year 1157. The first bank in India was started in the year 1770 by the Alexander & Co., an English Agency as “Bank of Hindustan” which failed in 1782 due to the closure of the

Agency House in India. The first bank in the modern sense was established in the Bengal Presidency as “Bank of Bengal” in the year 1806.

According to G. Crowther the modern banking has three ancestors in the history of banking in this world :-

i) The Merchants

ii) The Goldsmiths

iii) The Money Lenders

i) The Merchants

It were the merchant who first evolved the system of banking as the trading activities required remittances of money from one place to another place which is one of the important functions of a bank even now. Because of the possibility of theft of money during physical transportation of money, the traders began to issue the documents which were taken as titles of money. This system gave rise to the institution of “Hundi” which means a letter of transfer whereby a merchant directs another merchant to pay the bearer of Hundi the specified amount of money in the Hundi and debit this amount against the drawer of Hundi.

ii) The Goldsmiths

The second stage in the growth of banking was the role of goldsmiths. The business of goldsmiths was such that he had to secure safe to protect the gold against theft and take special precautions. In a period when paper was not in circulation and the money consisted of gold and silver, the people started leaving their precious bullion and coins in the custody of goldsmiths. As this practice spread, the goldsmiths started charging something for taking care of the gold and silver. As the evidence of receiving valuables, he stared to issue a receipt. Since the gold and silver coins had no mark of the owners, the goldsmiths started lending them. The goldsmiths were prepared to issue an equal amount of gold or silver money to the receipt holder, the goldsmith receipts became

like cheques as a medium of exchange and a means of payment by one merchant to the other merchant.

iii) The money lenders

The third stage in the growth of banking system is the changing of the character of goldsmiths into that of the money lenders. With the passing of time and on the basis of experience the goldsmiths found that the withdrawals of coins were much less than the deposits with them and it was not necessary to hold the whole of the coins with them. After keeping the contingency reserve, the goldsmiths started advancing the coins on loan by charging interest. In this way the goldsmith money lender became a banker who started performing two important functions of the modern banking system, that of accepting deposits and advancing loans. The only difference is that now it is the paper money and then its was gold or silver coins.

4.2 MEANING AND DEFINITION OF A BANK

It is very difficult to giver a precise definition of a bank due to the fact that a modern bank performs a variety of functions. Ordinarily a 'Bank' is an institution which deals with the money and credit in such a manner that it accepts deposits from the public and makes the surplus funds available to those who need them, and helps in remitting money from one place to another safely. Different economists have given different definition of a bank. Some of the important definitions are as under :

"A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it."

G.Crother

"Banking means the accepting for the purpose of Indian companies lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft or otherwise."

The Banking Companies (Regulation) Act, 1949

An ideal definition of a bank can be given as under :-

"A bank is a commercial establishment which deals in debts and aims at earning profits by accepting deposits from general public at large, which is repayable on demand or otherwise through cheques or bank drafts and otherwise which are used for lending to the borrowers or invested in Government securities."

4.3 TYPES OF BANKS

Banks are of various types and can be classified :

A. On the basis of Reserve Bank Schedule.

B. On the basis of ownership.

C. On the basis of domicile.

D. On the basis of functions.

A. On the basis of Reserve Bank Schedule

Bank can be of the following two types on the basis of Second Schedule of the Reserve Bank of India Act, 1934 :

i) Schedules Banks and

ii) Non-scheduled Banks

i) Scheduled Banks

All those banks which are included in the list of Schedule Second of the Reserve Bank of India are called the Scheduled Bank. Only those banks are included in the list of scheduled banks which satisfy the following conditions :

a) That it must have a paid up capital and reserves of Rs.5 lakhs.

b) That it must ensure the Reserve Bank that its operations are not detrimental to the interest of the depositors.

c) That it must be a corporation or a cooperative society and not a single owner firm or a partnership firm.

ii) Non-scheduled Banks

The banks which are not included in the second schedule of the Reserve Bank of India Act, 1934 are called non-scheduled banks. They are not included in the second schedule because they does not fulfill the three pre-conditions laid down in the act to qualify for the induction in the second schedule.

B. On the basis of Ownership

Banks can be classified on the basis of ownership in the following categories :

i) Public Sector Banks

ii) Private Sector Banks

iii) Cooperative Banks

i) Public Sector Banks

The banks which are owned or controlled by the Government are called “Public Sector Banks”. In 1955 the first public sector commercial bank was established by passing a special Act of Parliament which is known as State Bank of India. Subsequently the Government took over the majority of shares of other State Banks which were operating at the state levels namely State Bank of Patiala, State Bank of Bikaner & Jaipur, State bank of Travancore, State Bank of Mysore, State Bank of Indore, State Bank of Saurashtra and State Bank of Hyderabad presently working as subsidiaries of State Bank of India.

In the field of banking, the expansion of public sector was marked with the nationalization of 14 major commercial banks by Mrs. Indira Gandhi on July 19, 1969 through an ordinance. Again on April 15, 1980 another group of 6 commercial banks were nationalized with the deposits Rs.200 crores each, resulting in the total of 20 such banks. But due to the merger of New Bank of India with the Punjab National Bank in 1993-94, the number of nationalized bank has been reduced to 19. The State Bank of India and its seven subsidiaries had already been nationalized. The progressive nationalization of bank has increased the role of public sector banking in the country. In

1996 these nationalized commercial banks had 31,055 branches all over India whereas State Bank of India and its subsidiaries alone had 12,903 branches.

Under the new liberalization policy of the Government, The Oriental Bank of Commerce, State Bank of India, Corporation Bank, Bank of India and Bank of Baroda have offered their share to the general public and financial institutions and therefore these banks are no longer 100% owned by Government of India. Although majority of the shares is still with the Government, therefore these are still public sector banks.

ii) Private Sector Banks

On the contrary Private Sector Banks are those banks which are owned and controlled by the private sector i.e. private individuals and corporations. The private sector played a strategic role in the growth of joint stock banks in India. In 1951 there were in all 566 private sector banks of which 92 banks were scheduled banks and the remaining 474 were non-scheduled banks. At the time there was not even a single public sector bank. With the nationalization of banks in 1969 and 1980 their role in commercial banking had declined considerably. Since then the number of private sector banks is decreasing and the number of public sector banks is increasing.

iii) Co-operative Banks

The word ‘cooperative’ stands for working together. Therefore cooperative banking means an institution which is established on the principle of cooperation dealing in ordinary banking business. Cooperative banks are special type of banks doing ordinary banking business in which the members cooperate with each other for the promotion of their common economic interests.

Features of Cooperative Banking

Following are the distinguishing main features of a cooperative bank :-

i) Membership of Cooperative Banks is voluntary.

ii) Functions of a Cooperative Bank are common banking functions.

iii) Organization and management of a Cooperative Bank is based on democratic principles.

iv) Main objectives of a Cooperative bank are to promote economic, social and moral development of its members.

v) Basic principle of Cooperative Bank is equality.

Therefore, we can conclude and define a cooperative bank as under :

"Cooperative Bank is an institution established on cooperative basis which deals in ordinary banking business for the promotion of economic, social and moral development of its members on the principle of equality."

The short term agriculture credit institutions cater to the short term financial needs of the agriculturists which have the following three tier federal structure in cooperative :

a) At the Village level : Primary Agricultural Credit Societies

b) At the District level : Central Cooperative Banks

c) At the State level : State Cooperative Banks

C) On the basis of domicile

The banks can be classified into the following two categories on the basis of domicile :

i) Domestic Banks

ii) Foreign Banks

i) Domestic Banks

Those banks which are incorporated and registered in the India are called domestic banks.

ii) Foreign Banks

Foreign Banks are those banks which are set up in a foreign country with their control and management in the hands of head office in their country of origin but having

business branches in India. Foreign Banks are also known as Foreign Exchange Banks or Exchange Banks. Traditionally these banks were set up for financing the foreign trade in India and discounting the foreign exchange bills. But now these banks are also accepting deposits and making advances like other commercial banks in India

D) On the basis of functions

The banks can be classified on the basis of functions in the following categories :

i) Commercial Banks

ii) Industrial Banks

iii) Agricultural Banks

iv) Exchange Banks

v) Central Bank

i) Commercial Banks

Commercial Banks are those banks which perform all kinds of banking business and functions like accepting deposits, advancing loans, credit creation, and agency functions for their customers. Since their major portion of the deposits are for the short period, they advance only short term and medium term loans for business, trade and commerce. Majority of the commercial banks are in the public sector. Of late they have started giving long term loans also to compete in the commercial money market. These commercial banks are also called joint stock banks because they are constituted and organized in the same manner as the joint stock companies are constituted.

ii) Industrial Banks

The Industrial banks are those banks which provide medium term and long term finance to the industries for the purchase of land and building, plant and machinery and other industrial equipment. They also underwrite the shares and debentures of the industries and also subscribe to them. The main functions of an Industrial Banks are as follows :

i) They provide long term finance to the industries to purchase land and buildings, plant and machinery and construction of factory buildings.

ii) They also accept long term deposits.

iii) They underwrite the shares and debentures of the industry and sometimes subscribe to them.

In India there are number of financial institutions which perform the function of an Industrial Bank. Major financial institutions are as under :-

i) Industrial Development Bank of India (IDBI)

ii) Industrial Finance Corporation of India (IFCI)

iii) Industrial Credit and Investment Corporation of India (ICICI) and

iv) State Industrial Development Corporation such as Haryana State Industrial Development Corporation (HSIDC)

iii) Agriculture Banks

The needs of agricultural credit are different from that of industry, business, trade and commerce. Commercial banks and industrial banks do not deal with agriculture credit financing. An agriculturist has both type of needs :

i) He requires short term credit to purchase seeds, fertilizers and other inputs and

ii) He also requires long term credit to purchase land, to make permanent improvement on land, to purchase agricultural machinery and equipment such as tractors etc.

Agricultural credit is generally provided in India by the Cooperative institutions. The Cooperative Agricultural Credit Institutions are divided into two categories :-

A) Short term agricultural credit institutions and

B) Long term agricultural credit institutions

A) Short term agricultural credit institutions

The short term agricultural credit institutions cater to the short term financial needs of the agriculturists which have the following three tier federal structure :-

a) At the Village level : Primary Agricultural Credit Societies

b) At the District level : Central Cooperative Banks

c) At the State level : State Cooperative Banks

B) Long term agricultural credit institutions

The long term agricultural credit is provided by the Land Development Banks which were earlier known as Land Mortgage Banks. The land development banks provide long term to agriculturists for a period ranging from 5 years to 25 years.

iv) Exchange Banks

The exchange banks are those banks which deal in foreign exchange and specialised in financing the foreign trade. Therefore, they are also called foreign exchange banks. Foreign Exchange Banks are those banks which are set up in a foreign country with their control and management in the hands of head office in their country of origin but having business branches in India.

v) Central Bank

The Central Bank is the apex bank of a country which controls, regulates and supervises the banking, monetary and credit system of the country. The Central Bank is owned and controlled by the Government of the country. The Reserve Bank of India is the Central Bank in India. The important function of central bank are as follows :-

i) It acts as banker to the Government of the country.

ii) It also acts as agent and financial advisor to the Government of the country.

iii) It has the monopoly to issue currency of the country.

iv) It serves as the lender of the last resort.

v) It acts as the clearing house and keeps cash reserves of commercial banks.

4.4 FUNCTIONS OF COMMERCIAL BANKS

The Commercial Banks perform a variety of functions which can be divided in the following three categories :

1. Basic Functions
2. Agency Functions
3. General Utility Functions

1. Basic Functions

The basic functions of bank are those functions without performing which an institution cannot be called a banking institution at all. That is why these functions are also called primary or acid test function of a bank. The basic/primary/acid test function of a bank are :-

a) Accepting Deposits,

b) Advancing of Loans and

c) Credit Creation

a) Accepting Deposits

The first and the most important function of a bank is to accept deposits from those people who can save and spare for the safe custody with the bankers. It serves two purposes for the customers. On one hand their money is safe with the bank without any fear of theft and on the other hand they also earn interest as per the kind of saving they have made. For this purpose the banks have different kinds of deposit accounts to attract the people which are as under ;-

i) Saving Deposit Account

ii) Fixed Deposit Account

iii) Current Deposit Account

iv) Recurring Deposit Account

v) Home Loan Account

i) Saving Deposit Account

The Saving Bank Account is the most common bank account being utilized by the general public. The basic purpose of this account is to mobilise the small savings of the general public. Certain restrictions are imposed on the depositors regarding the number of withdrawals and amount to be withdrawn in a given period of time. Generally the rate of interest paid by the bank on these deposits is low as compared to recurring or fixed deposit account.

Cheque facility is also provided to the depositors with certain extra restrictions on the depositors. One of the conditions is that the depositor shall have to maintain a minimum balance in the account say Rs.500 which is otherwise very low in the case of account without the facility of the cheque book, say Rs.20 only. Some service charges are also imposed if the depositor uses the cheque facility at large levels.

ii) Fixed Deposit Account

This is an account where money can be deposited for a fixed period of time say one year or two years or three years of five years and so on. Once the money is deposited for a fixed period of time, the depositor is prohibited from withdrawal of money from the bank before the expiry of the stipulated period of time. The basic advantage to be customer is that he is offered interest at the higher rate of interest and the banker is free to utilize the money for that fixed period.

But where a customer is in need of money in any contingency or emergency, the bank also has the facility to provide loan against the fixed deposit receipt at liberal terms and conditions. Even if a customer insist on the withdrawal of his money the fixed deposit receipt can also be encashed before the expiry of the stipulated period of time with the condition that the customer shall not be entitled to higher rate of interest, but the

customer is allowed that rate of interest which is applicable on the saving deposit account as if the amount was deposited in the savings account.

iii) Current Deposit Account

In the savings bank account there are restrictions on the number of withdrawals that can be made in a day or a week or a month. Therefore it does not suit to the needs of traders and businessmen who has to make several payments daily and deposits money in a similar manner. Therefore, there is a facility for them in the shape of another account called Current Deposit Account. These accounts are generally maintained by the traders and businessmen who have to make a number of payments every day. Money from this account can be withdrawn by the account holder as many times as desired by the customer. Normally bank does not pay any interest on these current accounts, rather some incidental charges are charged by the banker as service charges. These accounts are also called demand deposits or demand liabilities.

The facility of Over Drafts is provided to the traders through these current accounts for which the banks charge interest on the outstanding balance of the customers. A limit is fixed by the bankers for withdrawal of over drafts and the customer is not allowed to withdraw more than that limit from his O/D current account. Say if a trader has an O/D limit of Rs.1,00,000 with a bank, he can withdraw money upto Rs.1,00,000 from the bank without depositing any money with the bank. But he cannot withdraw more than Rs.1,00,000. He shall have to pay interest on such withdrawals.

iv) Recurring Deposit Account

To encourage regular savings by the general public, another account is opened in the banks called Recurring Deposit Account. This account is preferred by the fixed income group, because a particular amount fixed at the time of opening the account has to be deposited in the account every month for a stipulated period of time. Say Rs.500 per month for a period of three years. In this case the customer is bound to deposit Rs.500 per month regularly for a period of three years. Generally the bank pays rate of interest

higher than that of a saving account and just equal to the fixed deposit account on such recurring deposit accounts.

The withdrawal of money is allowed only after the stipulated period of time along with the interest. Rather the account stands closed at the end of the stipulated period of time. In this case also the bank provide a facility to withdraw the money before the stipulated period of time in the case of any emergency. The bank shall allow rate of interest which is applicable on saving bank account in case the customer want to close the account before then stipulated period of time.

v) Home Loan Account

Home loan account facility has been introduced in some scheduled commercial banks to encourage savings for the purchasing of or construction of a house to live. In this account the customer is required to deposit a particular amount per month or half yearly or even yearly for a period of five years. After the stipulated period bank provide three to five times of the deposited amount a loan to the subscribers to purchase or construct a house. Rate of interest is also very attractive on this account nearly equal to that of the fixed deposit account. Even the rebate of Income Tax is also available on the amount contributed in this account under Section 88 of the Income Tax Act, 1961. Facility to close the account after the stipulated period of time is also allowed.

b) Advancing of Loans

Advancing of loans is the second acid test function of the commercial banks. After keeping certain cash reserves, the banks lend their deposits to the needy borrowers. It is one of the primary functions without which an institution can not be called a bank. The bank lends a certain percentage of the cash lying in the deposits on a higher rate of interest than it pays on such deposits. The longer the period for which the loan is required the higher is the rate of interest. Similarly higher the amount of loan, the higher shall be the rate of interest. Before advancing the loans the bank satisfy themselves about the credit worthiness of the borrowers. This is how a bank earns profits and carries on its

banking business. There are various types of loans which are provided by the banks to the borrowers. Some of the important ways of advancing loans are as under :-

i) Call Money Advances

ii) Cash Credits

iii) Overdrafts

iv) Discounting Bills of Exchange

v) Term Loans

i) Call Money Advances

The Call Money Market which is also known as inter-bank call money market deals with very short period loans called call loans. The Call Money Market is a very important constituent of the organized money market which functions as an immediate source of very short term loans. The major suppliers of the funds in the call money market are All Commercial Banks, State Bank of India (SBI), Life Insurance Corporation of India (LIC), General Insurance Corporation (GIC), Unit Trust of India (UTI) and Industrial Development Bank of India (IDBI) and the major borrowers are the scheduled Commercial Banks. No collateral securities are required against these call money market loans.

As the participants are mostly banks, it is also called inter-bank call money market. The Scheduled Commercial Banks use their surplus funds to lend for very short period to the bill brokers. The bill brokers and dealers in the stock exchanges generally borrow money at call from the commercial banks. The bill brokers in turn use them to discount or purchase the bills. Such funds are borrowed at the call rate which varies with the volume of funds lent by the commercial banks. When the brokers are asked to pay off the loans immediately, then they borrow from SBI, LIC, GIC, and UTI etc. These loans are granted by the commercial banks for a very short period, not exceeding seven days in any case. The borrowers have to repay the loan immediately when ever the lender bank call them back.

ii) Cash Credits

This is a type of loan which is provided to thy businessmen against their current assets such as shares, stocks, bonds etc. These loans are not based on credit worthiness or personal security of the customers. The bank provides this loan through opening an account in the name of the customer and allows them to withdraw borrowed amount of loan from time to time upto the limit fixed by the bank which is determined by the value of security provided by the borrowers. Interest is charge only on the amount of money actually withdrawn from the banks and not on the amount of the sanctioned amount of loan.

In some other cases certain banks follow a different procedure for cash credits. The whole amount of loan is credited to the current account of the borrower. In case of new customer a separate account is opened and amount of loan is transferred to it. The borrower is free to withdraw the money through cheques as and when required by the borrower. But in this case the borrower has to pay the interest on the whole amount credited in their accounts.

iii) Overdrafts

The facility of Over Drafts is provided to the traders and businessmen through current accounts for which the banks charge interest on the outstanding balance of the customers. A limit is fixed by the bankers for withdrawal of over drafts and the customer is not allowed to withdraw more than that limit from his Over Draft Current Account. This facility is required by the traders and businessmen because they issue several cheques in a day and similarly deposits so many cheques daily in their current accounts. They may not be knowing at a particular day that whether there is a balance in the account or not and their issued cheques are not dishonored so they are provided with the facility of overdrafts. Say it a trader has an Over Draft limit of Rs.2,00,000 with a bank, he can withdraw money upto Rs.2,00,000 from the bank without depositing any money

with the bank. But he cannot withdraw more than Rs.2,00,000. He shall have to pay interest on such withdrawals.

iv) Discounting Bills of Exchange

This is another popular type of lending by the commercial banks. A holder of a bill of exchange can get it discounted with a commercial bank. Bills of Exchange are also called the Commercial Bills and the market dealing with these bills is also called commercial bill market. Bills of exchange are those bills which are issued by the businessmen or firms in exchange of goods sold or purchased. The bill of exchange is a written unconditional order signed by the drawer (seller) requiring the drawee (buyer) to pay on demand or at a fixed future date, (usually three months after date written on the bill of exchange), a definite sum of money. After the bill has been drawn by the drawer (seller), it is accepted by the drawee (buyer) by countersigning the bill. Once the buyer puts his acceptance on the bill by signing it, it becomes a legal document. They are like post dated cheques issued by the buyers of goods for the goods received. The bill holder can get this bill discounted in the bill market if he wants the amount of the bill before its actual maturity. These bills of exchange are discounted and re-discounted by the commercial banks for lending credit to the bill brokers or for borrowing from the central bank. The bill of exchange market is not properly developed in India. The Reserve Bank of India introduced the bill market scheme in 1952. Its main aim was to provide finance against bills of exchange for 90 days. The scheduled commercial banks were allowed to convert a part of their advances into promissory notes for 90 days for lodging as collateral security for advances from Reserve Bank of India.

c) Term Loan

Earlier the commercial banks were advancing only short term loans. The commercial banks have also started advancing medium term and long term loans. Now the maturity period of term loans is more than one year. The amount of the loan sanctioned is either paid to the borrower or it is credited to the account of the borrower in the bank. The interest is charged on the whole amount of loan sanctioned irrespective of

the amount withdrawn by the borrower from his account. Repayment of the loan is accepted in lump sum or in the installments.

c) Credit Creation

Credit Creation is one of the basic functions of a commercial bank. A bank differ from the other financial institutions because it can create credit. Like other financial institutions the commercial banks also aim at earning profits. For this purpose they accept deposits and advance loans by keeping a small cash in reserve for day-to-day transactions. In the layman's language when a bank advances a loan, the bank creates credit or deposit. Every bank loan creates an equivalent deposit in the bank. Therefore the credit creation means multiple expansion of bank deposits. The word creation refers to the ability of the bank to expand deposits as a multiple of its reserves.

The credit creation refers to the unique power of the banks to multiply loans and advances, the hence deposits. With a little cash in hand, the banks can create additional purchasing power to a considerable extent. It is because of this multiple credit creation power that the commercial banks have been named the "factories of creating credit" or manufacturers of money.

2. Agency Functions

The commercial banks also perform certain agency functions for and on behalf of their customers. The bank acts as the agent of the customer while performing these functions. Such services of the banks are called agency services. Some of the important agency services are as under :-

i) Remittance of funds

ii) Collection and Payment of Credit Instruments

iii) Execution of Standing Orders

iv) Purchase and Sale of Securities

v) Collection of dividends on shares and interest on debentures

vi) Trustees and Executors of wills

vii) Representation and Correspondence

i) Remittance of funds

Commercial banks provide a safe remittance of funds of their customers from one place to another through cheques, bank drafts, telephone transfers etc.

ii) Collection and Payment of Credit Instruments

The commercial banks used to collect and pay various negotiable instruments like cheques, bills of exchange, promissory notes, hundis, etc.

iii) Execution of Standing Orders

The commercial banks also execute the standing orders and instruments of their customers for making various periodic payments like subscriptions, rents, insurance premiums and fees on behalf of the customers out of the accounts of their customers.

iv) Purchase and Sale of Securities

The commercial banks also undertake the sale and purchase of securities like shares, stocks, bonds, debentures etc., on behalf of their customers performing the function as a broker agent.

v) Collection of dividends on shares and interest on debentures

Commercial banks also make collection of dividends announces by the companies of which the customer of the bank is a shareholder, and also collects the interest on the debentures which becomes due on particular dates generally half yearly or annually.

vi) Trustees and Executors of wills

The commercial banks preserves the wills of their customers as their trustees and execute the wills after the death of the customer as per the will as the executors.

vii) Representation and Correspondence

The commercial banks also act as the representative and correspondents of their customers and get passports, traveler's tickets, book vehicles and plots for their customers on the directions of the customers.

3. General Utility Functions

In addition to basic functions and agency functions the commercial banks also provide general utility services for their customers which are needed in the various walks of life and the commercial banks provide a helping hand in solving the general problems of the customers, like safety from loss or theft and so many other facilities some them are as under :-

i) Locker Facility
ii) Traveler's Cheque Facility
iii) Gift Cheque Facility
iv) Letter of Credit
v) Underwriting Contract
vi) Provides Statistical Data
vii) Foreign Exchange Facilities
viii) Merchant Banking Services
ix) Acting as Referee

i) Locker Facility

The commercial banks provide locker facility to its customers at very reasonable charges which is not possible at the premises of the customers. The customers can

avail the facility of lockers in different sizes according to the needs of the customers. The locker charges also varies with the size of the lockers. The customers can keep their valuables in the and important documents in these lockers for safety. Lockers can be operated in the usual business hour of the bank on all working days.

ii) Traveler's Cheque Facility

Where a customers want to visit long distant places and also need money, they need not carry the money with them which is not safe during long distant journeys and there is always a fear of loss or theft during the journey. The commercial banks provide a unique facility through traveler's cheque. The customers can get traveler's cheques from the banks and travel without the fear of theft or loss of money. Wherever they need money they can approach the branch of the bank in that city and encash the traveler's cheque according to the need.

iii) Gift Cheque Facility

Some commercial banks also provide the facility of issuing gift cheques in the denomination of different amounts according to the needs of the customers, say Rs.11, 21, 51, 101, 501 and so on. This facility is provided for the special occasions for the customers and normally the banks do not charge any thing for issuing these gift cheques.

iv) Letter of Credit

The commercial banks also help their customers by providing another unique service by providing the letter of credit in which the bank certifies the credit worthiness of the customers. These letters of credit are used in the long distant trade and specially in foreign trade where the parties do not know each other and it is bank which provide the safety to them regarding their credit worthiness by issuing letter of credit.

v) Underwriting Contract

The commercial banks underwrite the securities issued by the public or private companies and Government securities. It is the reputation of the bank which matters in the underwriting contracts. Where the bank is a very reputed one, the investors shall not have any hesitation in investing the money in which their banker is the underwriter. In case the public do not purchase the securities, it is the underwriting bank which has to purchase the securities upto the amount of which the bank has underwritten.

vi) Provides Statistical Data

The commercial banks also help their customers by providing them important information through statistical data. Commercial banks collect statistical data in which important information relating to industry, trade, commerce, money and banking is collected and published in their journals and bulletins containing research articles on the economic and financial matters. Such statistical data maybe useful for the customers in dealing with their own business, trade or commerce.

vii) Foreign Exchange Facilities

The commercial banks also deals in the business of foreign currencies. These banks provide foreign exchange and also discount the foreign bills of exchange. Some commercial banks have also opened special branches for the foreign exchange services to the non-resident Indians settled abroad.

viii) Merchant Banking Services

The commercial banks have also started providing merchant banking facilities. The Banking Commission Report, 1972 emphasised the need of creating specialised institutions to cater financial requirements of different sectors exclusively and examined the need of setting up merchant banking institutions. Commission recommended the setting up of merchant banking institution.

Consequently in 1972 itself State Bank of India started its merchant banking division. Since then a number of other commercial banks and financial institutions started their merchant banking divisions. Now the merchant banking firms in private sector have started gearing up to meet the challenge posed by commercial banks and financial institutions in the field of merchant banking in India.

ix) Acting as Referee

The commercial banks are the best source of seeking information about the creditworthiness of the customers. Banks may be referred for seeking information regarding credit worthiness, financial position, business reputation and respectability of their customers.

4.5 SUMMARY

A bank is an institution which deals with the money and credit in such a manner that it accepts deposits from the public and makes the surplus funds available to those who need them, and helps in remitting money from one place to another safely. The banks can be classified on the basis of Reserve Bank Schedule, ownership, domicile and functions. The commercial banks perform basic functions, agency functions and general utility functions.

4.6 KEYWORDS

Bank: A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who acquire it.

Scheduled Bank: All those banks which are included in the list of Schedule Second of the Reserve Bank of India are called Scheduled Bank.

Public Sector Bank: The bank which is owned or controlled by the Government is known as public sector bank.

Commercial Bank: Commercial bank is that bank which performs all kinds of banking business and functions like accepting deposits, advancing loans, credit creation and agency functions for

their customers.

Cash Credit: It is a type of loan which is provided to the businessman against their current assets.

4.7 SELF ASSESSMENT QUESTIONS

1. Define a bank. Explain the origin and growth of banking in the modern sense.
2. Why is an institution called a bank? What are the different types of a bank?
3. Explain the functions which a modern bank perform.

4.8 SUGGESTED READINGS

Sundharam, K.P.M., and Varshney, P.N., Banking and Financial System, Sultan Chand and Sons, New Delhi.
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Maheshwari, S.N., Banking Law and Practice, Kalyani Publishers, Ludhiana.
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LESSON-5
MANAGEMENT OF RISK IN FINANCIAL SERVICES

STRUCTURE

5.0 Objective
5.1 Introduction
5.2 Concept of risk
5.3 Types of risk
5.4 Risk Management
5.5 Summary
5.6 Keywords
5.7 Self Assessment Questions
5.8 Suggested Readings

5.0 OBJECTIVE

After reading this lesson you should be able to

(a) Define risk and explain the types of risk.

(b) Discuss the different aspects of risk management.

5.1 INTRODUCTION

Risk has two components namely uncertainty and exposure. If both are not present, there is no risk. If a man jumps out of an airplane with a parachute on his back, he may be uncertain as to whether or not the chute will open. He is taking risk because he is exposed to that uncertainty. If the chute fails to open, he will suffer personally. In this example, a typical spectator on the ground would not be taking risk. They may be equally uncertain as to whether the chute will open, but they have no personal exposure to that uncertainty. Exceptions might include: A spectator who is owed money by the man

jumping from the plane. A spectator who is a member of the man's family. Such spectators do face risk because they may suffer financially and/or emotionally should the man's chute fail to open. They are exposed and uncertain.

5.2 CONCEPT OF RISK

A synonym for uncertainty is ignorance. We face risk because we are ignorant about the future. After all, if we were omniscient, there would be no risk. Because ignorance is a personal experience, risk is necessarily subjective. Consider another example: A person is heading to the airport to catch a flight. The weather is threatening and it is possible the flight has been cancelled. The individual is uncertain as to the status of the flight and faces exposure to that uncertainty. His travel plans will be disrupted if the flight is cancelled. Accordingly, he faces risk. Suppose another person is also heading to the airport to catch the same flight. This person has called ahead and confirmed that the flight is not cancelled. Accordingly, he has less uncertainty and faces lower risk. In this example, there are two individuals exposed to the same event. Because they have different levels of uncertainty, they face different levels of risk. Risk is subjective. Institutions can reduce some risks simply by researching them. A bank can reduce its credit risk by getting to know its borrowers. A brokerage firm can reduce market risk by being knowledgeable about the markets it operates in. Risk is a personal experience, not only because it is subjective, but because it is individuals who suffer the consequences of risk. Although we may speak of companies taking risk, in actuality, companies are merely conduits for risk. Ultimately, all risks which flow through an organization accrue to individuals stock holders, creditors, employees, customers, board members, etc.

5.3 TYPES OF RISK

Following are the types of risk:

1. Credit risk

Credit risk is risk due to uncertainty in a counterparty's (also called an obligor or credit's) ability to meet its obligations. Because there are many types of counterparties—from individuals to sovereign governments— and many different types of obligations—from auto loans to derivatives transactions—credit risk takes many forms. Institutions manage it in different ways. In assessing credit risk from a single counterparty, an institution must consider three issues:

(a) *Default probability:* What is the likelihood that the counterparty will default on its obligation either over the life of the obligation or over some specified horizon, such as a year? Calculated for a one-year horizon, this may be called the expected default frequency.

(b) *Credit exposure:* In the event of a default, how large will the outstanding obligation be when the default occurs?

(c) *Recovery rate:* In the event of default, what fraction of the exposure may be recovered through bankruptcy proceedings or some other form of settlement?

When we speak of the credit quality of an obligation, this refers generally to the counterparty's ability to perform on that obligation. This encompasses both the obligation's default probability and anticipated recovery rate. To place credit exposure and credit quality in perspective, recall that every risk comprises two elements: exposure and uncertainty. For credit risk, credit exposure represents the former, and credit quality represents the latter.

For loans to individuals or small businesses, credit quality is typically assessed through a process of credit scoring. Prior to extending credit, a bank or other lender will obtain information about the party requesting a loan. In the case of a bank issuing credits cards, this might include the party's annual income, existing debts, whether they rent or own a home, etc. A standard formula is applied to the information to produce a number,

which is called a credit score. Based upon the credit score, the lending institution will decide whether or not to extend credit. The process is formulaic and highly standardized.

Many forms of credit risk— especially those associated with larger institutional counterparties are complicated, unique or are of such a nature that it is worth assessing them in a less formulaic manner. The term credit analysis is used to describe any process for assessing the credit quality of counterparty. While the term can encompass credit scoring, it is more commonly used to refer to processes that entail human judgement. One or more people, called credit analysts, will review information about the counterparty. This might include its balance sheet, income statement, recent trends in its industry, the current economic environment, etc. They may also assess the exact nature of an obligation. For example, secured debt generally has higher credit quality than does subordinated debt of the same issuer. Based upon their analysis, they assign the counterparty (or the specific obligation) a credit rating, which can be used for making credit decisions.

Many banks, investment managers and insurance companies hire their own credit analysts who prepare credit ratings for internal use. Other firms— including Standard and Poor's, Moody's and Fitch— are in the business of developing credit ratings for use by investors or other third parties. Institutions that have publicly traded debt hire one or more of them to prepare credit ratings for their debt. Those credit ratings are then distributed for little or no charge to investors. Some regulators also develop credit ratings. In the United States, the National Association of Insurance Commissioners publishes credit ratings that are used for calculating capital charges for bond portfolios held by insurance companies.

The manner in which credit exposure is assessed is highly dependent on the nature of the obligation. If a bank has loaned money to a firm, the bank might calculate its credit exposure as the outstanding balance on the loan. Suppose instead that the bank has extended a line of credit to a firm, but none of the line has yet been drawn down. The immediate credit exposure is zero, but this doesn't reflect the fact that the firm has the

right to draw on the line of credit. Indeed, if the firm gets into financial distress, it can be expected to draw down on the credit line prior to any bankruptcy. A simple solution is for the bank to consider its credit exposure to be equal to the total line of credit. However, this may overstates the credit exposure. Another approach would be to calculate the credit exposure as being some fraction of the total line of credit, with the fraction determined based upon an analysis of prior experience with similar credits.

Derivative instruments represent contingent obligations, so they entail credit risk. While it is possible to measure the mark-to-market credit exposure of derivatives based upon their current market values, this metric provides an incomplete picture. For example, many derivatives, such as forwards or swaps, have a market value of zero when they are first entered into. Mark-to-market exposure— which is based only on current market values— does not capture the potential for market values to increase over time. For that purposes some probabilistic metric of potential credit exposure must be used.

There are many ways that credit risk can be managed or mitigated. The first line of defense is the use of credit scoring or credit analysis to avoid extending credit to parties that entail excessive credit risk. Credit risk limits are widely used. These generally specify the maximum exposure a firm is willing to take to counterparty. Industry limits or country limits may also be established to limit the sum credit exposure a firm is willing to take to counterparties in a particular industry or country. Calculation of exposure under such limits requires some form of credit risk modelling. Transactions may be structured to include collateralization or various credit enhancements. Credit risks can be hedged with credit derivatives. Finally, firms can hold capital against outstanding credit exposures.

2. Legal risk

Legal risk is risk from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations. Depending on an institution’s circumstances, legal risk may entail such issues as:

(a) *Contract formation*: What constitutes a legitimate contract? Is an oral agreement sufficient, or must there be a legal document?

(b) *Capacity*: Does a counterparty have the capacity to enter into a transaction? For example, in 1992, the United Kingdom's House of Lords determined that the London Borough of Hammersmith and Fulham lacked capacity to transact in derivatives linked to interest rates. Not only were contracts dating back to the mid-1980s with the borough declared void, but contracts with over 130 other councils were effectively invalidated. A number of derivatives dealers suffered losses.

(c) *Legality of derivatives transactions*: In some jurisdictions there are issues relating to whether certain derivatives could be deemed gambling contracts and thus made unenforceable. This was a significant concern during the early days of OTC derivatives markets.

(d) *Perfection of an interest in collateral*: A claim is perfected if it is senior to any existing or future third-party claims in the event of bankruptcy. A perfected interest represents a lien on collateral. Requirements to perfect a claim can be complex and vary by both jurisdiction and the nature of the collateral.

(e) *Netting agreements*: Under what circumstances will a closeout netting agreement be enforceable?

(f) *Contract frustration*: Might unforeseen circumstances in validate a contract? For example, if a contract is linked to an index or currency that ceases to exist, will the contract become invalid?

Legal risk can be a particular problem for institutions who transact business across borders. Not only are they exposed to uncertainty relating to the laws of multiple jurisdictions, but they also face uncertainty as to which jurisdiction will have authority over any particular legal issue.

3. Liquidity risk

Liquidity risk is a financial risk due to uncertain liquidity. An institution might lose liquidity if its credit rating falls, it experiences sudden, unexpected cash outflows, or some other event causes counterparties to avoid trading with or lending to the institution. A firm is also exposed to liquidity risk if markets on which it depends are subject to loss of liquidity.

Liquidity risk tends to compound other risks. If a trading organization has position in an illiquid asset, its limited ability to liquidate that position at short notice will compound its market risk. Suppose a firm has offsetting cash flows with two different counterparties on a given day. If the counterparty that owes it a payment defaults the firm will have to raise cash from other sources to make its payment. Should it be unable to do so, it too is default. Here, liquidity risk is compounding credit risk.

Obviously, a position can be hedged against market risk but still entail liquidity risk. This is true in the above credit risk example— the two payments are offsetting, so they entail credit risk but not market risk. Another example is the 1993 Metallgesellschaft Debacle. Futures were used to hedge an OTC obligation. It is debatable whether the hedge was effective from a market risk standpoint, but it was the liquidity crisis caused by staggering margin calls on the futures that forced Metallgescellschaft to unwind the positions.

Accordingly, liquidity risk has to be managed in addition to market, credit and other risks. Because of its tendency to compound other risks, it is difficult or impossible to isolate liquidity risk. In all but the most simple of circumstances, comprehensive metrics of liquidity risk don’t exist. Certain techniques of asset-liability management can be applied to assessing liquidity risk. A simple test for liquidity risk is to look at future net cash flows on a day-by-day basis. Any day that has a sizeable negative net cash flow is of concern. Such an analysis can be supplemented with stress testing. Look at net cash flows on a day-to-day basis assuming that an important counterparty defaults.

Obviously, such analyses cannot take into account contingent cash flows, such as cash flows from derivatives or mortgage-backed securities. If an organization's cash flows are largely contingent, liquidity risk may be assessed using some form of scenario analysis. Construct multiple scenarios for market movements and defaults over a given period of time. Assess day-to-day cash flows under each scenario. Because balance sheets differed so significantly from one organization to the next. There is little standardization in how such analyses are implemented. Regulators are primarily concerned about systemic implications of liquidity risk.

4. Market risk

Business activities entail a variety of risk. For convenience, we distinguish between different categories of risk: market risk, credit risk, liquidity risk, etc. Although such categorization is convenient, it is only informal. Usage and definitions vary. Boundaries between categories are blurred. A loss due to widening credit spreads may reasonably be called a market loss or a credit loss, so market risk and credit risk overlap. Liquidity risk compounds other risks, such as market risk and credit risk. It cannot be divorced from the risks it compounds.

An important but somewhat ambiguous distinguish is that between market risk and business risk. Market risk is exposure to the uncertain market value of a portfolio. A trader holds a portfolio of commodity forwards. She knows what its market value is today, but she is uncertain as to its market value a week form today. She faces market risk. Business risk is exposure to uncertainty in economic value that cannot be market risk. Business risk is exposure to uncertainty in economic value that cannot be market-to-market. The distinction between market risk and busuiness risk parallels the distinction between market-value accounting and book-value accounting. Suppose a New England electricity wholesaler is long a forward contract for on-peak electricity delivered over the next 3 months. There is an active forward market for such electricity, so the contract can be marked to market daily. Daily profits and losses on the contract reflect market risk. Suppose the firm also owns a power plant with an expected useful life of 30 years. Power

plants change hands infrequently, and electricity forward curves don't exist out to 30 years. The plant cannot be marked to market on a regular basis. In the absence of market values, market risk is not a meaningful notion. Uncertainty in the economic value of the power plant represents business risk.

The distinction between market risk and business risk is ambiguous because there is a vast 'gray zone' between the two. There are many instruments for which markets exist, but the markets are illiquid. Mark-to-market values are not usually available, but mark-to-model values provide a more-or-less accurate reflection of fair value. Do these instruments pose business risk or market risk? The decision is important because firms employ fundamentally different techniques for managing the two risks.

Business risk is managed with a long-term focus. Techniques include the careful development of business plans and appropriate management oversight. Book-value accounting is generally used, so the issue of day-to-day performance is not material. The focus is on achieving a good return on investment over an extended horizon.

Market risk is managed with a short-term focus. Long-term losses are avoided by avoiding losses from one day to the next. On a tactical level, traders and portfolio managers employ a variety of risk metrics— duration and convexity, the Greeks, beta etc.— to assess their exposures. These allow them to identify and reduce any exposures they might consider excessive. On a more strategic level, organizations manage market risk by applying risk limits to traders' or portfolio managers' activities. Increasingly, value-at-risk is being used to define and monitor these limits. Some organizations also apply stress testing to their portfolios.

5. Operational risk

During the 1990s, financial firms and other corporations focused increasing attention on the emerging field of financial risk management. This was motivated by concerns about the risks posed by the rapidly growing OTC derivatives markets; a spat of

publicized financial losses, including those of Barings Bank, Orange Country and Metallgesellschaft; regulatory initiatives, especially the Basle Accord.

During the early part of the decade, much of the focus was on techniques for measuring and managing market risk. As the decade progressed, this shifted to techniques of measuring and managing portfolio credit risk. By the end of the decade, firms and regulators were increasingly focusing on risks “other than market and credit risk.” These came to be collectively called operational risks. This catch-all category of risks was understood to include, employee errors, systems failures, fire, floods or other losses to physical assets, fraud or other criminal activity. Firms had always managed these risks in various ways. The new goal was to do so in a more systematic manner. The approach would parallel— and be integrated with— those that were proving effective with market risk and credit risk.

The task appeared daunting. Financial institutions and regulators had to dedicate considerable resources to managing market risk and credit risk, and those were well-known, narrowly-defined risks. Operational risk was anything but well defined. People disagreed about the specific contingencies that should be considered operational risks— should legal risks, tax risks, management incompetence or reputational risks be included? The debate was more than academic. It would shape the scope of initiatives to manage operational risk.

Another problem was that operational contingencies don’t always fall into near categories. Losses can result from a complex confluence of events, which makes it difficult to predict or model contingencies. In 1996, the Credit Lyonnais trading floor was destroyed by fire. This might be categorized as a loss due to fire. It might also be categorized as a loss due to fraud— investigators suspect employees deliberately set the fire in order to destroy evidence of fraud.

There was considerable debate about the extent to which opertional risks should be assessed with qualitative or quantitative means. Market risks are generally assessed quantitatively with tools such as value-at-risk. Credit risk is assessed with a combination

of quantitative and qualitative means. Quantitative models are employed for such things as projecting potential credit exposure, assessing portfolio credit risk or assigning credit scores. Still, the process of assessing corporate credit quality retains qualitative elements. For operational risk, certain contingencies are particularly amenable to quantitative techniques. For example, settlement errors in a trading operation's back office happen with sufficient regularity that they can be modelled statistically. Other contingencies affect financial institutions infrequently and are of a non-uniform nature which makes modelling difficult. Examples include acts of terrorism, natural disasters and trader fraud.

Working to define the Basle II accord, regulators made considerable progress in designing a framework for managing operational risk. This was reported in a consultative document (2001). Researchers and financial institutions pursued initiatives. Techniques were borrowed from fields such as actuarial science and engineering reliability analysis. By 2002, a general framework for assessing and managing operational risk was emerging. Much work remains to be done, and operational risk management will never be standardized to the extent to which market risk and credit risk management are— if only because of the differences between financial institutions. However, general conclusions can be drawn.

The Basle Committee defines operational risk as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition has been widely adopted in the literature, either precisely or with slightly different wording. Each institution must interpret the definition in light of its own business lines, procedures and systems. Each institution must identify the specific operational contingencies it is exposed to.

Most operational risk are best managed within the departments in which they arise. Information technology professionals are best suited for addressing systems-related risks. Back office staff are best suited to address settlement risks, etc. However, overall planning, coordination, and monitoring should be provided by a centralized operational risk management department. This should closely coordinate with market risk and credit

risk management departments within an overall enterprise risk management framework. Contingencies broadly fall into two categories: (a) those that occur frequently and entail modest losses; and (b) those that occur infrequently but may entail substantial losses. Both can and should be assessed using qualitative techniques such as management oversight, employee questionnaires, exit interviews, management self-assessment, and internal audit. Both can also be assessed using quantitative techniques. Contingencies of an infrequent but potentially catastrophic nature can, to some extent, be modelled using techniques developed for property and casualty insurance. However, contingencies that arise more frequently are more amendable to statistical analysis.

Statistical modelling requires data. For operational contingencies, two forms of data are useful: data on historical loss events, and data on risk indicators. Loss events run the gamut— settlement errors, systems failures, petty fraud, customer lawsuits, etc. Losses may be direct (as in the case of theft) or indirect (as in the case of damage to the institution's reputation). There are three ways data on loss events can be categorized: cause, event and consequence. For example, an event might be a mis-entered trade. The cause might be inadequate training, a systems problem or employee fatigue. Consequences might include a market loss, fees paid to a counterparty, a lawsuit or damage to the firm's reputation. Any event may have multiple causes or consequences. Tracking all three dimensions of loss events facilitates the construction of event matrices, identifying the frequency with which certain causes are associated with specific events and consequences. Even with no further analysis, such matrices can identify for management areas for improvement in procedures, training, staffing, etc.

Risk indicators differ from loss events. They are not associated with specific losses, but indicate the general level of operational risk. Examples of risk indicators a firm might tract are: amount of overtime being performed by back-office staff, staffing levels, daily transaction volumes, employee turnover rates, and systems downtime.

From a modelling standpoint, the goal is to find relationships between specific risk indicators and corresponding rates of loss events. If such relationships can be identified, then risk indicators can be used to identify periods of elevated operational risk.

Once operational risks have been— qualitatively or quantitatively— assessed, the next steps to somehow manage them. Solutions may attempt to avoid certain risks, accept others, but attempt to mitigate their consequences, or simply accept some risks. Specific techniques might include: employee training, close managements oversight, segregation of duties, purchase of insurance, employee background checks, exiting certain businesses, etc. Choice of techniques will depend upon a cost-benefit analysis.

Inevitably, some risks are unavoidable or, from a cost-benefit standpoint, are worth taking. These should be capitalized, so another step in operational risk management is the calculation of reasonable capital charges. Many financial institutions are incorporating operational risk capital charges into their capital allocation systems.

6. Model risk

Because institutions rely heavily on models for pricing financial transactions or monitoring risks, they are exposed to model risk. This is the risk that models are applied to tasks for which they are inappropriate or are otherwise implemented incorrectly. Examples of model risk include: A bank uses a value at risk (VAR) to monitor market risk. When the VAR measure was implemented, the bank’s traders took little spread risk. It was coded with a fixed spread assumption. Since that time, the traders have started taking significant spread risk but do not realize that the model is failing to capture it. Option pricing models incorporate a risk-neutral assumption. Such models may produce erroneous results if used to measure risk or other quantities that depend upon investor risk preferences. A brokerage firm is expanding its derivatives operation into South America. They fail to modify their pricing models to reflect the lack of liquidity in certain markets. Consequently, they underestimate the cost of hedging their positions. Model risks generally categorized as a form of operational risk.

5.4 RISK MANAGEMENT

Risk management, as it is understood today, largely emerged during the early 1990s, but the term ‘risk management’ was used long before this. Since the 1960s, it has— and frequently still is — used to describe techniques for addressing insurable risks. This form of ‘risk management’ encompasses: risk reduction through safety, quality control and hazard education, alternative risk financing, including self-insurance and captive insurance, and the purchase of traditional insurance products, as suitable.

More recently, derivative dealers have promoted ‘risk management’ as the use of derivatives to hedge or customize market-risk exposures. For this reason, derivative instruments are sometimes called ‘risk management products’. The new ‘risk management’ that evolved during the 1990s is different from either of the earlier forms. It views derivatives as a problem as much as a solution. It focuses on reporting, oversight and segregation of duties within organizations.

So what is this management? Risk management— or financial risk management, should we want to distinguish it from other uses of the word— can be defined as *practices by which a firm optimizes the manner in which it takes financial risk.* It includes monitoring of risk taking activities, upholding relevant policies and procedures, and distributing risk-related reports.

Note that risk management is not about optimizing risk in some sense. That is the province of the board of directors and senior management, perhaps working with more tactical risk takers such as traders or portfolio managers. No, risk management is about optimizing the manner in which risk is taken. Accordingly risk management is not about managing anything. It is really about facilitating.

A related concept is enterprise risk management, which is the extension of financial risk management, in some sense, to non-financial contingencies. It is somewhat elusive concept that means different things to different people. Firms have experimented with the concept, combining financial risk management, insurance purchasing, and

contingency planning into a single business unit. A challenge has been the culture clash between the worlds of finance and insurance. Few professionals are expert in both.

Organizationally, financial risk management is implemented in different ways. There may be, within the board of directors, a risk committee. Usually, there is some sort of risk oversight committee, comprising senior managers. In practice, various names are given to these two committees. A senior manager called the head of risk management or chief risk officer (CRO), reports to the risk oversight committee. This head of risk management may oversee a single department called the risk management department. Professionals working within that department, called risk managers, are responsible for facilitating the taking of applicable financial risks— market risks, credit risks and operational risks— by other departments within the firm. In larger organizations, there may be more specialization. The head of risk management might oversee three professionals: a head of market risk management, a head of credit risk management and a head or operational risk management.

Each would oversee a respective department. Other arrangements are also possible. Functionally, there are four aspects of financial risk management. Success depends upon a positive corporate culture, actively observed policies and procedures, effective use of technology, independence of risk management professionals.

(a) Culture

It is a fact that an organization will only manage risk if its members want to manage risk. Regulators struggle with this every day. They can force a bank to implement a multi-million dollar value-at-risk system. They can require an insurance company to implement hundreds of pages of procedures. But they cannot force an institution to effectively manage risk.

It is individuals who decide whether or not they are going to manage organizational risk. Unfortunately, there is a big incentive for them to choose not to. The very sorts of behaviour which reduce organizational risk entail significant personal risk.

For example: A clerk who blows the whistle on a trader may get the problem resolved, or he may end up without a job. A board member who wishes to expand the use of risk management must stick her neck out. At the risk of appearing alarmist, she must suggest that potentially significant problems are not currently being addressed. A trader— whose compensation depends primarily upon his reputation in the organization— can only manage risk if he first acknowledges that he is capable of making mistakes. An executive who wishes to address the risk of employee fraud may risk alienating his own colleagues.

Risk management is about rocking the boat, asking questions and challenging the establishment. No one can manage risk if they are not prepared to take risk. While individual initiative is critical, it is corporate culture that facilitates the process. Corporate culture defines what behaviour the members of an organization will condone— and what behaviour they will shun. Corporate culture plays a critical role in risk management because it defines the risks which an individual must personally take if they are going to help managing organizational risks. A positive risk culture is one which promotes individual responsibility and is supportive of risk taking. Characteristics include:

Individuals making decisions: Group decision making can be ineffective if no one is personally accountable. When a single person makes a decision— possibly with the help or approval of others— that individual is accountable. His reputation is on the line, so he will carefully analyze the issues before proposing a course of action.

Questioning: In a positive risk culture, people question everything. Not only does this identify better ways to do things. It also ensures that people understand and appreciate procedures.

Admissions of ignorance: Mark Twain once said, “I was gratified to be able to answer promptly. I said I don’t know.” Admitting that we don’t know entails significant personal risk. A positive risk culture supports such honesty at every level of an organization.

No risk culture is perfect. Fortunately, few are beyond repair. The challenge of risk management is to honestly assess an organization's culture, and then work to improve it.

(b) Policies and procedures

When you mention policies and procedures, people are likely to roll their eyes, as thoughts of red tape and bureaucracy flood their thoughts. This is unfortunate. Used correctly, procedures are a powerful tool of risk management. The purpose of policies and procedures is to empower people. They specify how people can accomplish what needs to be done. It is only when policies and procedures are neglected or abused that they become an impediment.

The success of policies and procedures depends critically upon a positive risk culture. Hundreds of pages of procedures, neatly printed and sitting on a shelf, are useless if no one uses them. However, even a simple set of procedures can make an enormous difference for an organization if people believe in them and take personal responsibility for upholding them. Procedures systematize the process of risk management. Consider market risk limits. These are a form of procedure which systematize oversight of market risk. They make explicit how much risk is too much risk for any given segment of a portfolio.

Without risk limits, someone would have to track the risks being taken by individual traders and apply their own subjective judgement as to how much is too much. Should they decide to act on their subjective judgement that a trader is taking too much risk, the affected trader may reasonably feel that the decision is arbitrary or unfair— he might ask: "what about the market opportunity I was pursuing or the client whose needs I was trying to meet?"

Whenever procedures do not exist, there is increased potential for disagreement, misunderstanding and conflict. A lack of procedures increases the personal risk that individuals must take if they are going to manage organizational risk. Accordingly, a lack

of procedures tends to promote inaction. Effective procedures, on the other hand, empower people. They lay out specifically what people should do— and what they should not do— in a given situation. By reducing uncertainty— individual risk— they promote action. Examples of procedures include:

Board procedures: Every board of directors or governing body should operate under a set of procedures which address conflicts of interest, clarify personal responsibility and facilitate the discussion and resolution of difficult or contentious issues.

Lines of reporting: Everyone in an organization should report to a single person. The line of reporting should be explicit. A worthwhile illustration for this is the Bank of England's report on the Barings collapse. That report identifies four different people who may have had oversight responsibility for Nick Leeson.

Trading authority: Whenever an organization engages in a new form of market activity— such as the use of a new form of transaction, a new hedging strategy or proprietary trading— there should first be a formal review and approval process. A streamlined procedure should apply for granting new responsibility to any trader.

Risk limits: Market and credit risk limits represent procedures for managing risk. There should also be procedures for establishing and reviewing such limits in order to assure that the system of limits remains effective.

An organization should have formal procedures for changing policies or procedures. Experienced risk managers know that proposals for an informal or hasty change to procedures sometimes indicate an effort to cover up something that existing procedures would otherwise highlight. Also, because procedures become outdated over time, it is easy for organizations to change how they operate without formally recognizing that the change is taking place. Informal practices evolve out of habit, instead of by a deliberate process. Because they may be adopted out of necessity or convenience— without considering how they impact organizational risk— they, too, are a source of risk.

Often, periods of change are a time of increased risk for an organization. Procedures for changing policies or procedures are an excellent mechanism that encourage people to recognize changes as they are taking place and formally address the risks that they pose.

(c) Technology

The primary role technology plays in risk management is risk assessment and communication. Technology is employed to quantify or otherwise summarize risks as they are being taken. It then communicates this information to decision-makers, as appropriate. Technology might include a VAR system or portfolio credit risk system. It can include financial engineering technology for independently marking to market positions. It may include an interactive risk report that is electronically circulated to managers every day. For many institutions, such as banks or securities firms, technology is a critical component of risk management. For other organizations, including some non-financial corporations or pension plans, technology plays a lesser role.

For institutions, which rely heavily on technology, there is always a risk of the cart being placed before the horse, with technology becoming the focus of risk management. If an organization launches a risk management initiatives by first allocating money to the project and then issuing an request for proposal, that can be a warning sign. A more staged approach starts off by recognizing that risk management is primarily about people— how they think and how they interact with one another. Technology is just a tool. In the wrong hands, it is worse than useless, but applied appropriately, it can transform an organization.

A good approach to implementing an enterprise risk management initiative is initially allocate minimal funding for the initiative, but ensure that board members or senior management or other supervisors are involved in the process. Start by planning a risk management strategy that involves no technology at all. This can be an empowering exercise. It focuses participants on the procedural and cultural issues of risk management.

Ultimately, it is these which determine the success of an initiative. Once you have decided on a strategy for managing risk, then determine where technology needs to be incorporated or where it can enhance the strategy.

(d) Independence

For risk management to succeed, risk managers must be independent of risk taking functions within the organization. Holton (2004) defines independence as comprising the following four criteria: Risk managers have reporting lines that are independent from those of risk taking functions. Except at the highest levels, risk takers have no input on the performance reviews, compensation or promotion of risk managers, and conversely. Employees cannot switch from one role to the other. Those hired into risk management stay in risk management; those hired as risk takers stay as risk takers. Risk managers do not take risk on the firm's behalf. They do not advise on which risks to take. They express no opinions about the desirability of any particular risks.

The first three items are straightforward. The fourth is more subtle— or perhaps, controversial. It speaks to the very heart of what constitutes risk management. Let's briefly address the first three items and then proceed to the question: what is the role of risk management, anyway? Enron's experience with risk management is instructive. The firm maintained a risk management function staffed with capable employees. Lines of reporting were reasonably independent in theory, but less so in practice. The group's mark-to-market valuations were subject to adjustment by management. The group had few career risk managers. Enron maintained a fluid workforce. Employees were constantly on the lookout for their next internal transfer. Those who rotated through risk management were no different. A trader or structure whose deal a risk manager scrutinized one day might be in a position to offer that risk manager a new position the next. Astute risk managers were careful to not burn bridges. Even worse, risk managers were subject to Enron's "rank and yank" system of performance review. Under that system, anyone could contribute feedback on anyone, and the consequences of a bad review were draconian. Risk managers who blocked deals could expect to suffer in 'rank

and yank." Of the above four criteria for independence, Enron was weak on the first but utterly failed to satisfy the second two. Despite the sophistication of individual employees, risk management at Enron was hollow.

Proceeding now to the fourth criteria for independence, we want to distinguish between risk taking and risk management. Within firms, there are strategic and tactical risk takers. The CEO and other senior managers are strategic risk takers. They formulate a strategy for the firm that entails taking certain risks. They communicate the strategy to tactical risk takers— including traders, structures, and asset managers— whose job it is to implement that strategy. This is how business have operated for hundreds of years, so where do risk managers fit in? While not typically acknowledged, there are two competing models.

According to one model, strategic and tactical risk takers need help taking risk. Under this theory, super risk takers— risk managers— are required to intervene. They identify risks that should be avoided and, in doing so, risks that should be taken. In this manner, risk managers help the less qualified strategic and tactical risk takers do their jobs.

There is much wrong with this model. First, it is redundant. If strategic or tactical risk takers are not capable of doing their jobs, the answer is not to hire a super risk taker to do it for them. Rather, it is to replace them with strategic and tactical risk takers who are up to the task. Second, it undermines accountability. If a trade turns sour, is the trader at fault, or is the risk manager who failed to block the deal? Third, it leads to conflict. While strategic risk takers will never feel threatened that a super risk taker might usurp their prerogatives, tactical risk takers often do. At some firms, the result has been a cold war between the front and middle offices. Finally, risk managers are positioned to be used as scapegoats. With corporate scandals fresh in memory, one can understand why some senior executives may be all too happy ascribing full responsibility for risk taking to a chief risk officer. With this model, risk management can become a device for executives to manage career risk as opposed to a device for managing corporate risk.

The alternative model is that risk managers are facilitators. Strategic and tactical risk takers are responsible for deciding what risks to take. Risk managers facilitate the process by ensuring effective communication between the two groups. They help strategic risk takers communicate through policies, procedures and risk limits. They help tactical risk takers communicate by preparing risk reports that describe the risks they are taking. To avoid the pitfalls of the risk-managers as super-risk-takers model, risk managers must have no authority to take risk on the firm's behalf. They do not advise on risk taking issues because, if their advice is routinely followed, they will become de facto risk takers. To avoid the semblance of giving advice, they express no opinions about the desirability of taking any particular risks. It is one thing for a risk manager to measure risk. It is entirely another for the risk manager to express an opinion that the risk is too large or otherwise not worth taking. With risk managers not expressing opinions, tactical risk takers don't feel threatened… so there is no cold war. With risk managers not responsible for taking risks, there is little possibility of shifting lame to them when things go wrong.

5.5 SUMMARY

Risk has two components namely uncertainty and exposure. If both are not present, there is no risk. There are six types of risk. Credit risk is the risk due to uncertainty in a counterparty's ability to meet its obligations. Credit analysis is used to describe any process for assessing the credit quality of counterparty. Legal risk can be a particular problem for institutions who transact business across borders. A firm is exposed to liquidity risk if markets on which it depends are subject to loss of liquidity. Market risk is exposure to the uncertain market value of a portfolio. Most operational risks are managed within the departments in which they arise. Four aspects of financial risk management are positive corporate culture, actively observed policies and procedures, efficient use of technology and independence of risk management professionals.

5.6 KEY WORDS

Credit risk: It is the risk due to uncertainty in a creditor's ability to meet its obligations.

Legal risk: It is the risk from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations.

Liquidity risk: Liquidity risk is the financial risk due to uncertain liquidity.

Market risk: Market risk is exposure to the uncertain marked value of a portfolio.

Operational risk: Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.

Risk management: It includes monitoring of risk taking activities, upholding relevant policies and procedures, and distributing risk-related reports.

5.7 SELF ASSESSMENT QUESTIONS

1. Define risk. Discuss the various types of risk.
2. In assessing the credit risk, what factors should be kept in mind? Discuss.
3. What do you man by risk management? Explain the different aspects of financial risk management.

5.8 SUGGESTED READINGS

Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

Khan, M.Y., Financial Services, Tata McGraw Hill, New Delhi.

Kothari, C.R., Investment Banking and Customer Service, Arihand Publishers, Jaipur.

Machiraju, H.R., Merchant Banking, New Age International Publishers, New Delhi.

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LESSON-6

MUTUAL FUND

STRUCTURE

6.0 Objective
6.1 Introduction
6.2 Concept and origin of the Mutual Fund
6.3 Types of Funds/Classification of Funds
6.4 Importance of Mutual Funds
6.5 Risks Associated with Mutual Fund
6.6 Organization of the Fund
6.7 Operation of the Fund
6.8 Facilities available to Investors
6.9 Net Asset Value
6.10 Investors Rights
6.11 General Guidelines
6.12 Mutual Funds 2000
6.13 Selection of a Fund
6.14 Commercial Banks and Mutual Funds
6.15 Mutual Funds Abroad
6.16 Mutual Funds in India
6.17 Reasons for Slow Growth
6.18 Mutual Funds for whom?
6.19 Summary
6.20 Keywords
6.21 Self Assessment Questions
6.22 Suggested Readings

6.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define mutual fund and explain various types of mutual funds.

(b) Discuss the importance and risks associated with mutual fund.

(c) Explain the general guidelines issued by Govt. of India for investor protection.

(d) Present a scenario of mutual funds in India.

6.1 INTRODUCTION

Of late, mutual funds have become a hot favourite of millions of people all over the world. The driving force of mutual funds is the ‘safety of the principal’ guaranteed, plus the added advantage of capital appreciation together with the income earned in the form of interest or dividend. People prefer mutual funds to bank deposits, life insurance and even bonds because with a little money, they can get into the investment game. One can own a string of blue chips like ITC, TISCO, Reliance etc., through mutual funds. Thus, mutual funds act as a gateway to enter into big companies hitherto inaccessible to an ordinary investor with his small investment.

6.2 CONCEPT AND ORIGIN OF MUTUAL FUNDS

To state in simple words, a mutual fund collects the savings from small investors, invest them in Government and other corporate securities and earn income through interest and dividends, besides capital gains. It works on the principle of ‘small drops of water make a big ocean’. For instance, if one has Rs.1000 to invest, it may not fetch very much on its own. But, when it is pooled with Rs. 1000 each from a lot of other people, then, one could create a ‘big fund’ large enough to invest in a wide varieties of shares and debentures on a commanding scale and thus, to enjoy the economies of large scale operations. Hence, a mutual fund is nothing but a form of collective investment. It is

formed by the coming together of a number of investors who transfer their surplus funds to a professionally qualified organization to manage it. To get the surplus funds from investors, the fund adopts a simple technique. Each fund is divided into a small fraction called “units” of equal value. Each investor is allocated units in proportion to the size of his investment. Thus, every investor, whether big or small, will have a stake in the fund and can enjoy the wide portfolio of the investment held by the fund. Hence, mutual funds enable millions of small and large investors to participate in and derive the benefit of the capital market growth. It has emerged as a popular vehicle of creation of wealth due to high return, lower cost and diversified risk.

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1993 defines a mutual fund as “a fund established in the form of a trust by a sponsor, to raise monies by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations”.

These mutual funds are referred to as Unit Trusts in the U.K. and as open end investment companies in the U.S.A. Therefore, Kamm, J.O. defines an open end investment company as “an organization formed for the investment of funds obtained from individuals and institutional investors who in exchange for the funds receive shares which can be redeemed at any time at their underlying asset value”.

According to Weston J. Fred and Brigham, Eugene, F., Unit Trusts are “Corporations which accept dollars from savers and then use these dollars to buy stocks, long term bonds, short term debt instruments issued by business or government units; these corporations pool funds and thus reduce risk by diversification”.

Thus, mutual funds are corporations which pool funds by selling their own shares and reduce risk by diversification.

Fund Unit Vs. Share : Just like shares, the price of units of a fund is also quoted in the market. This price is governed basically by the value of the underlying investments held by that fund. At this juncture, one should not confuse a mutual fund investment on units

with that of an investment on equity shares. Investment on equity share represents investment in a particular company alone. On the other hand, investment on an unit of a Fund represents investment in the parts of shares of a large number of companies. This itself gives an idea how safe the units are. If a particular company fails the share-holders of that company are affected very much whereas the unit holders of that company are able to withstand that risk by means of their profitable holdings in other companies shares.

Again, investment on equity shares can be used as a tool by speculators and inveterate stock market enthusiasts with a view to gaining abnormal profits. These people play an investment game in the stock market on the basis of daily movement of prices. But, mutual funds cannot be invested for such purposes and the mutual fund is not at all concerned with the daily ebbs and flows of the market. In short, mutual fund is not the right investment vehicle for speculators. Mutual funds are, therefore, suitable only to genuine investors whereas shares are suitable to both the genuine investors and the speculators.

Origin of the Fund

The origin of the concept of mutual fund dates back to the very dawn of commercial history. It is said that Egyptians and Phoenicians sold their shares in vessels and caravans with a view to spreading the risk attached with these risky ventures. However, the real credit of introducing the modern concept of mutual fund goes to the Foreign and Colonial Government Trust of London established in 1868. Thereafter, a large number of close-ended mutual funds were formed in the U.S.A. in 1930’s followed by many countries in Europe, the Far East and Latin America. In most of the countries, both open and close-ended types were popular. In India, it gained momentum only in 1980, though it began in the year 1964 with the Unit Trust of India launching its first fund, the Unit Scheme 1964.

6.3 TYPES OF FUNDS/CLASSIFICATION OF FUNDS

In the investment market, one can find a variety of investors with different needs, objectives and risk taking capacities. For instance, a young businessman would like to get more capital appreciation for his funds and he would be prepared to take greater risk than a person who is just on the verge of his retiring age. So, it is very difficult to offer one fund to satisfy all the requirements of investors. Just as one shoe is not suitable for all legs, one fund is not suitable to meet the vast requirements of all investors. Therefore, many types of funds are available to the investor. It is completely left to the discretion of the investor to choose any one of them depending upon his requirement and his risk taking capacity.

Mutual fund schemes can broadly be classified into many types as given below:

1. On the basis of execution and operation

(A) Close-ended Funds

Under this scheme, the corpus of the fund and its duration are prefixed. In other words, the corpus of the fund and the number of units are determined in advance. Once the subscription reaches the pre-determined level, the entry of investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding. Thus, the fund ceases to be a fund, after the final distribution.

Features : The main features of the close-ended funds are:

(i) The period and/or the target amount of the fund is definite and fixed beforehand.

(ii) Once the period is over and/or the target is reached, the door is closed for the investors. They cannot purchase any more units.

(iii) These units are publicly traded through stock exchange and generally, there is no repurchase facility by the fund.

(iv) The main objective of this fund is capital appreciation.

(v) The whole fund is available for the entire duration of the scheme and there will not be any redemption demands before its maturity. Hence, the fund manager can manage the investments efficiently and profitably without the necessity of maintaining and liquidity.

(vi) At the time of redemption, the entire investment pertaining to a closed-end scheme is liquidated and the proceeds are distributed among the unit holders.

(vii) From the investor's point of view, it may attract more tax since the entire capital appreciation is realized in toto at one stage itself.

(viii) If the market condition is not favourable, it may also affect the investor since he may not get the full benefit of capital appreciation in the value of the investment.

(ix) Generally, the prices of closed-end scheme units are quoted at a discount of upto 40 percent below their Net Asset Value (NAV).

(B) Open-ended Funds

It is just the opposite of close-ended funds. Under this scheme, the size of the fund and/or the period of the fund is not pre-determined. The investors are free to buy and sell any number of units at any point of time. For instance, the Unit Scheme (1964) of the Unit Trust of India is an open ended one, both in terms of period and target amount. Anybody can buy this unit at any time and sell it also at any time at his discretion.

The main features of the Open-Ended Funds are :

(i) The investor is assured of regular income at periodic intervals, say half-yearly or yearly and so on.

(ii) The main objective of this type of Fund is to declare regular dividends and not capital appreciation.

(iii) The pattern of investment is oriented towards high and fixed income yielding securities like debentures, bonds etc.

(iv) This is best suited to the old are retired people who may not have any regular income.

(v) It concerns itself with short run gains only.

(B) Pure Growth Funds (Growth Oriented Funds)

Unlike the Income Funds, Growth Funds concentrate mainly on long run gains i.e., capital appreciation. They do not offer regular income and they aim at capital appreciation in the long run. Hence, they have been described as "Nest Eggs" investments.

The main features of the Growth Funds are :

(i) The growth oriented fund aims at meeting the investors' need for capital appreciation.

(ii) The investment strategy therefore, conforms to the fund objective by investing the funds predominantly on equities with high growth potential.

(iii) The fund tries to get capital appreciation by taking much risks and investing on risk bearing equities and high growth equity shares.

(iv) The fund may declare dividend, but its principal objective is only capital appreciation.

(v) This is best suited to salaried and business people who have high risk bearing capacity and ability to defer liquidity. They can accumulate wealth for future needs.

(C) Balanced Funds

This is otherwise called income-cum-growth fund. It is nothing but a combination of both income and growth funds. It aims at distributing regular income as well as capital

appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

(D) Specialised Funds

Besides the above, large number of specialised funds are in existence abroad. They offer special schemes so as to meet the specific needs of specific categories of people like pensioners, widows etc. There are also funds for investments in securities of specified areas. For instance, Japan Fund, South Korea Fund etc. In fact, these funds open the door for foreign investors to invest on the domestic securities of these countries.

Again certain funds may be confined to one particular sector or industry like fertilizer, automobiles, petroleum etc. These funds carry heavy risk since the entire investment is in one industry. But, there are high risk taking investors who prefer this type of fund. Of course, in such cases, the rewards may be commensurate with the risk taken. At times, it may be erratic. The best example of this type is the Petroleum Industry Funds in the U.S.A.

(E) Money-Market Mutual Funds (MMMFs)

These funds are basically open ended mutual funds and as such they have all the features of the open ended fund. But, they invest in highly liquid and safe securities like commercial paper, banker’s acceptances, certificates of deposits, treasury bills etc. These instruments are called money market instruments. They take the place of shares, debentures and bonds in a capital market. They pay money market rates of interest. These funds are called ‘money funds’ in the U.S.A. and they have been functioning since 1972. Investors generally use it as a “parking place” or “stop gap arrangement” for their cash resources till they finally decide about the proper avenue for their investment i.e., long term financial assets like bonds and stocks.

Since MMMFs are a new concept in India, the RBI has laid down certain stringent regulations. For instance, the entry to MMMFs is restricted only to scheduled commercial banks and their subsidiaries. MMMFs can invest only in specified short term money

market instruments like certificate of deposits, commercial papers and 182 days treasury bills. They can also lend to call market. These funds go for safe and liquid investment. Frequent realization of interest and redemption of fund at short notice are the special features of the fund. These funds will not be subject to reserve requirements. The re-purchase could be subject to a minimum lock in period of 3 months.

(F) Taxation Funds

A taxation fund is basically a growth oriented fund. But, it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March. In India, at present the law relating to tax rebates is covered under section 88 of the Income Tax Act, 1961. An investor is entitled to get 20% rebate in Income Tax for investments made under this fund subject to a maximum investment of Rs.10,000/- per annum. The Tax Saving Magnum of SBI Capital Market Limited is the best example for the domestic type. UTI's US $60 million India Fund, based in the USA, is an example for the foreign type.

OTHER CLASSIFICATION

(G) Leveraged Funds

These funds are also called borrowed funds since they are used primarily to increase the size of the value of portfolio of a mutual fund. When the value increases, the earning capacity of the fund also increases. The gains are distributed to the unit holders. This is resorted to only when the gains from the borrowed funds are more than the cost of borrowed funds.

(H) Dual Funds

This is a special kind of closed end fund. It provides a single investment opportunity for two different types of investors. For this purpose, it sells two types of investment stocks viz., income shares and capital shares. Those investors who seek

current investment income can purchase income shares. They receive all the interest and dividends earned from the entire investment portfolio. However, they are guaranteed a minimum annual dividend payment. The holders of capital shares receive all the capital gains earned on those shares and they are not entitled to receive any dividend of any type. In this respect, the dual fund is different from a balanced fund.

(I) Index Funds

Index funds refer to those funds where the portfolios are designed in such a way that they reflect the composition of some broad based market index. This is done by holding securities in the same proportion as the index itself. The value of these index linked funds will automatically go up whenever the market index goes up and vice-versa. Since the construction of portfolio is entirely based upon maintaining proper proportions of the index being followed, it involves less administrative expenses, lower transaction costs, less number of portfolio managers etc. It is so because only fewer purchases and sales of securities would take place.

(J) Bond Funds

These funds have portfolios consisting mainly of fixed income securities like bonds. the main thrust of these funds is mostly on income rather than capital gains. They differ from income funds in the sense income funds offer an average returns higher than that from bank deposits and also capital gains lesser than that in equity shares.

(K) Aggressive Growth Funds

These funds are just the opposite of bond funds. These funds are capital gains oriented and thus the thrust area of these funds is capital gains. Hence, these funds are generally invested in speculative stocks. They may also use specialised investment techniques like short term trading, option writing etc. Naturally, these funds tend to be volatile in nature.

(L) Off-Shore Mutual Funds

Off-shore mutual funds are those funds which are meant for non-residential investors. In other words, the sources of investments for these funds are from abroad. So, they are regulated by the provisions of the foreign countries where those funds are registered. These funds facilitate flow of funds across different countries, with free and efficient movement of capital for investment and repatriation. Off-shore funds are preferred to direct foreign investment, since, it does not allow foreign domination over host country's corporate sector. However, these funds involve much currency and country risk and hence they generally yield higher return.

In India, these funds are subject to the approval of the Department of Economic Affairs, Ministry of Finance and the RBI monitors such funds by issuing directions then and there. In India, a number of off-shore funds exist. 'India Fund' and 'India Growth Fund' were floated by the UTI in U.K. and U.S.A. respectively. The State Bank of India floated the India Magnum Fund in Netherlands. 'The Indo-Suez Himalayan Fund N.V.' was launched by Canbank Mutual Fund in collaboration with Indo-Suez Asia Investment Services Ltd. It also floated 'Commonwealth Equity Fund'.

6.4 IMPORTANCE OF MUTUAL FUNDS

The mutual fund industry has grown at a phenomenal rate in the recent past. One can witness a revolution in the mutual fund industry in view of its importance to the investors in general and the country's economy at large. The following are some of the important advantages of mutual funds :

(i) Channelising Savings for Investment

Mutual funds act as a vehicle in galvanizing the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. A number of schemes are being offered by MFs so as to meet the varied requirements of the masses, and thus, savings are directed towards capital

investments directly. In the absence of MFs, these savings would have remained idle. Thus, the whole economy benefits due to the cost efficient and optimum use and allocation of scarce financial and real resources in the economy for its speedy development.

(ii) Offering Wide Portfolio Investment

Small and medium investors used to burn their fingers in stock exchange operations with a relatively modest outlay. If they invest in a select few shares, some may even sink without a trace never to rise again. Now, these investors can enjoy the wide portfolio of th investment held by the mutual fund. The fund diversifies its risks by investing on a large varieties of shares and bonds which cannot be done by small and medium investors. This is in accordance with the maxim ‘Not to lay all eggs in one basket’. These funds have large amounts at their disposal, and so, they carry a clout in respect of stock exchange transactions. They are in a position to have a balanced portfolio which is free from risks. Thus MF’s provide instantaneous portfolio diversification. The risk diversification which a pool of savings through mutual funds can achieve cannot be attained by a single investor’s savings.

(iii) Providing Better Yields

The pooling of funds from a large number of customers enables the fund to have large funds at its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus, they are able to command better market rates and lower rates of brokerage. So, they provide better yields to their customers. They also enjoy the economies of large scale and can reduce the cost of capital market participation. The transaction costs of large investments are definitely lower than that of small investments. In fact, all the profits of a mutual fund are passed on to the investors by way of dividends and capital appreciation. The expenses pertaining to a particular scheme alone are charged to the respective scheme. Most of the mutual funds so far floated have given a dividend at the rate ranging between 12% p.a. and 17% p.a. It

is fairly a good yield. It is an ideal vehicle for those who look for long term capital appreciation.

(iv) Rendering Expertise Investment Service at Low Cost

The management of the fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus, investors are assured of quality services in their best interest. Due to the complex nature of the securities market, a single investor cannot do all these works by himself or he cannot go to a professional manager who manages individual portfolios. In such a case, he may charge hefty management fee. The intermediation fee is the lowest being one per cent in the case of a mutual fund.

(v) Providing Research Service

A mutual fund is able to command vast resources and hence it is possible for it to have an in depth study and carry out research on corporate securities. Each fund maintains a large research team which constantly analyses the companies and the industries and recommends the fund to buy or sell a particular share. Thus, investments are made purely on the basis of a thorough research. Since research involves a lot of time, efforts and expenditure, an individual investor cannot take up this work. By investing in a mutual fund, the investor gets the benefit of the research done by the fund.

(vi) Offering Tax Benefits

Certain funds offer tax benefits to its customers. Thus, apart from dividends, interest and capital appreciation, investors also stand to get the benefit of tax concession. For instance, under section 80L of the Income Tax Act, a sum of Rs.10,000 received as dividend (Rs.13000 to UTI) from a MF is deductible from the gross total income. Under the wealth Tax Act, investments in MF are exempted upto Rs. 5 lakhs.

The mutual funds themselves are totally exempt from tax on all income on their investments. But, all other companies have to pay taxes and they can declare dividends only from the profits after tax. But, mutual funds to do not deduct tax at source from dividends. This is really a boon to investors.

(vii) Introducing Flexible Investment Schedule

Some mutual funds have permitted the investors to exchange their units from one scheme to another and this flexibility is a great boon to investors. Income Units can be exchanged for growth units depending upon the performance of the funds. One can not derive such a flexibility in any other investments.

(viii) Providing Greater Affordability and Liquidity

Even a very small investor can afford to invest in mutual funds. They provide an attractive and cost effective alternative to direct purchase of shares. In the absence of MFs, small investors cannot think of participating in a number of investments with such a meager sum. Again, there is grater liquidity. Units can be sold to the fund at anytime at the Net Asset Value and thus quick access to liquid cash is assured. Besides, branches of the sponsoring bank is always ready to provide loan facility against the unit certificates.

(ix) Simplified Record Keeping

An investor with just an investment in 500 shares or so in 3 or 4 companies has to keep proper records of dividend payments, bonus issues, price movements, purchase or sale instruction, brokerage and other related items. It is very tedious and consumes a lot of time. One may even forget to record the rights issue and may have to forfeit the same. Thus, record keeping is the biggest problem for small and medium investors. Now, a mutual fund offers a single investment source facility, i.e., a single buy order of 100 units from a mutual fund is equivalent to investment in more than 100 companies. The investor has to keep a record of only one deal with the Mutual Fund. Even if he does not keep a

record, the MF sends statements very often to the investor. Thus, by investing in MFs, the record keeping work is also passed on to the fund.

(x) Supporting Capital Market

Mutual funds play a vital role in supporting the development of capital markets. The mutual funds make the capital market active by means of providing a sustainable domestic source of demand for capital market instruments. In other words, the savings of the people are directed towards investments in capital markets through these mutual funds. Thus, funds serve as a conduit for dis-intermediating bank deposits into stocks, shares and bonds. Mutual Funds also provide a valuable liquidity to the capital market, and thus, the market is made very active and stable. When foreign investors and speculators exit and re-enter the markets en masse, mutual funds keep the market stable and liquid. In the absence of mutual funds, the prices of shares would be subject to wide price fluctuation due to the exit and re-entry of speculators into the capital market en masse. Thus, it is rending an excellent support to the capital market and helping in the process of institutionalization of the market.

(xi) Promoting Industrial Development

The economic development of any nation depends upon its industrial advancement and agricultural development. All industrial units have to raise their funds by resorting to the capital market by the issue of shares and debentures. The mutual funds not only create a demand for these capital market instruments but also supply a large source of funds to the market, and thus, the industries are assured of their capital requirements. In fact the entry of mutual funds has enhanced the demand for India’s stock and bonds. Thus, mutual funds provide financial resources to the industries at market rates.

(xii) Acting as Substitute for Initial Public Offerings (IPOs)

In most cases investors are not able to get allotment in IPOs of companies because they are often oversubscribed many time. Moroever, they have to apply for a minimum of

500 shares which is very difficult particularly for small investors. But, in mutual funds, allotment is more or less guaranteed. Mutual Funds are also guaranteed a certain percentage of IPOs by companies. Thus, by participating in MFs, investors are able to get the satisfaction of participating in hundreds of varieties of companies.

(xiii) Reducing the Marketing Cost of New Issues

Moreover the mutual funds help to reduce the marketing cost of the new issues. The promoters used to allot a major share of the Initial Public offering to the mutual funds and thus they are saved from the marketing cost of such issues.

(xiv) Keeping the Money Market Active

An individual investor can not have any access to money market instruments since the minimum amount of investment is out of his reach. On the other hand, mutual funds keep the money market active by investing money on the money market instruments. In fact, the availability of more money market instruments itself is a good sign for a developed money market which is very essential for the successful functioning of the central bank in a country.

Thus mutual funds provide stability to share prices, safety to investors and resources to prospective entrepreneurs.

6.5 RISKS ASSOCIATED WITH MUTUAL FUNDS

Mutual Funds are not free from risks. It is so because basically the mutual funds also invest their funds in the stock market on shares which are volatile in nature and are not risk free. Hence, the following risk are inherent in their dealings :

(i) Market Risks

In general, there are certain risks associated with every kind of investment on shares. They are called market risks. These market risks can be reduced, but cannot be completely eliminated even by a good investment management. The prices of shares are

subject to wide price fluctuations depending upon market conditions over which nobody has a control. Moreover, every economy has to pass through a cycle-boom, recession, slump and recovery. The phase of the business cycle affects the market conditions to a larger extent.

(ii) Scheme Risks

There are certain risks inherent in the scheme itself. It all depends upon the nature of the scheme. For instance, in a pure growth scheme, risks are greater. It is obvious because if one expects more returns as in the case of a growth scheme, one has to take more risks.

(iii) Investment Risk

Whether the Mutual Fund makes money in shares or loses depends upon the investment expertise of the Asset Management Company (AMC). If the investment advice goes wrong, the fund has to suffer a lot. The investment expertise of various funds are different and it is reflected on the returns which they offer to investors.

(iv) Business Risk

The corpus of a mutual fund might have been invested in a company's shares. If the business of that company suffers any set back, it cannot declare any dividend. It may even go to the extent of winding up its business. Though the mutual fund can withstand such a risk, its income paying capacity is affected.

(v) Political Risks

Successive Governments bring with them fancy new economic ideologies and policies. It is often said that many economic decisions are politically motivated. Changes in Government bring in the risk of uncertainty which every player in the financial service industry has to face. So mutual funds are no exception to it.

6.6 ORGANIZATION OF THE FUND

The structure of mutual fund operations in India envisages a three tier establishment namely :

(i) A sponsor institution to promote the fund

(ii) A team of trustees to oversee the operations and to provide checks for the efficient, profitable and transparent operations of the fund and

(iii) An Asset Management Company AMC) to actually deal with the funds.

Sponsoring Institution : The company which sets up the Mutual Fund is called the sponsor. The SEBI has laid down certain criteria to be met by the sponsor. These criteria mainly deal with adequate experience, good past track record, net worth etc.

Trustees : Trustees are people with long experience and good integrity in their respective fields. They carry the crucial responsibility of safeguarding the interest of investors. For this purpose, they monitor the operations of the different schemes. They have wide ranging powers and they can even dismiss Asset Management Companies with the approval of the SEBI.

Asset Management Company (AMC) : The AMC actually manages the funds of the various schemes. The AMC employs a large number of professionals to make investments, carry out research and to do agent and investor servicing. In fact, the success of any Mutual Fund depends upon the efficiency of this AMC. The AMC submits a quarterly report on the functioning f the mutual fund to the trustees who will guide and control the AMC.

6.7 OPERATION OF THE FUND

A mutual fund invites the prospective investors to join the fund by offering various schemes so as to suit to the requirements of different categories of investors. The resources of individual investors are pooled together and the investors are issued units/shares for the money invested. The amount so collected is invested in capital

market instruments like shares and debentures and money market instruments like treasury bills, commercial papers, etc.

For managing this fund, a mutual fund gets an annual fee of 1.25% of funds managed at the maximum as fixed by the SEBI (MF) Regulations, 1993 and if the funds exceed Rs.100 crores, it is only 1%. It can not take more than that. Of course regular expenses like custodial fee, cost of dividend warrants, fee for registration, the asset management fee etc. are debited to the respective scheme. These expenses cannot exceed 3% of the assets in the respective schemes each year. The remaining amount is given back to the investors in full.

6.8 FACILITIES AVAILABLE TO INVESTORS

Mutual funds provide following facilities to the investors :

(i) Repurchase Facilities

The units of closed ended schemes must be compulsorily listed in recognized stock exchanges. Such units can be sold or bought at market prices. But, units of open ended schemes are not at all listed and hence they have to be bought only from the fund. So, the fund reserves the right to buy back the units from its members. This process of buying back the units from the investors by the fund is called repurchase facility. This is available in both schemes so as to provide liquidity to investors. The price fixed for this purpose is called repurchase price.

(ii) Reissue Facilities

In the case of open ended schemes, units can be bought only from the fund and not in the open market. The units bought from the investors are again reissued to those who are interested in purchasing them. The price fixed for this purpose is called re-issue price.

(iii) Roll Over Facilities

At the time of redemption, the investor is given an option to reinvest his entire investment once again for another term. An investor can overcome an adverse market condition prevailing at the time of redemption by resorting to this roll over facility. This is applicable in the case of close-ended funds.

(iv) Lateral Shifting Facilities

Some mutual funds permit the investors to shift from one scheme to another on the basis of the Net Asset Value with a view to providing total flexibility in their operation. This is done without any discount on the fund and without any additional charges. This is a great privilege given to the investors. This shifting is called ‘lateral shifting’.

6.9 NET ASSET VALUE

The repurchase price is always linked to the Net Asset Value(NAV). The NAV is nothing but the market price of each unit of a particular scheme in relation to all the assets of the scheme. It can otherwise be called “the intrinsic value” of each unit. This value is a true indicator of the performance of the fund. If the NAV is more than the face value of the unit, it clearly indicates that the money invested on that unit has appreciated and the fund has performed well.

Illustration

For instance, Fortune Mutual Fund has introduced a scheme called Millionaire Scheme. The scheme size is Rs.100 crores. The value of each units is Rs.10/-. It has invested all the funds in shares and debentures and the market value of the investment comes to Rs.200 crores.

$$\text{Now NAV} = \frac{\text{200 crores}}{\text{100 crores}} \times \text{value of each unit}$$

= 2 x 10 = 20

Thus, the value of each unit of Rs.10/- is worth Rs.20.

Hence the NAV = Rs. 20.

This NAV forms the basis for fixing the repurchase price and reissue price.

The investor can call up the fund any time to find out the NAV. Some MFs publish the NAV weekly in two or three leading daily newspapers.

6.10 INVESTORS RIGHTS

The SEBI (MF) Regulations, 1993 contains specific provisions with regard to investor servicing. Certain rights have been guaranteed to the investors as per these regulations. They are as follows :

(i) Unit Certificates

An investor has a right to receive his unit certificates on allotment within a period of 10 weeks from the date of closure of subscription lists in the case of a close ended scheme and 6 weeks from the date of closure of the initial offer in the case of an open ended scheme.

(ii) Transfer of Units

An investor is entitled to get the unit certificates transferred within a period of 30 days from the date of lodgement of the certificates along with the relevant transfer forms.

(iii) Refund of Application Money

If a mutual fund is not able to collect the statutory minimum amount it has to return the application money as refund within a period of 6 weeks from the date of closure of subscription lists. If the refund is delayed beyond this period, each applicant is entitled to get the refund with interest at the rate of 15% p.a. for the period of delay.

(iv) Audited Annual Report

Every mutual fund is under an obligation to its investors to publish the audited annual report and unaudited half yearly report through prominent newspapers in respect of each of its schemes within 6 months and 3 months respectively of the date of closure of accounts.

6.11 GENERAL GUIDELINES

For proper functioning of mutual funds and for ensuring investor protection, the following important guidelines have been framed by the Government of India:

(A) General

(i) Money market mutual funds would be regulated by the RBI while other mutual funds would be regulated by the Securities and Exchange Board of India (SEBI)

(ii) Mutual Fund shall be established in the form of Trusts under the Indian Trust Act and be authorized for business by the SEBI.

(iii) Mutual Funds shall be operated only by separately established Asset Management Companies (AMCs).

(iv) At least 50% of the Board of AMC must be independent directors who have no connections with the sponsoring organization. The directors must have professional experience of at least 10 years in the relevant fields such as portfolio management, financial administration, etc.

(v) The AMC should have a minimum net worth of Rs.5 crores at all times.

(vi) The SEBI is given the power to withdraw the authorization given to any AMC if it is found to be not serving the best interest of investors as well as the capital market. It is not applicable to bank sponsored AMCs.

(B) Business Activities

(i) Both AMCs and trustees should be treated as two separate legal entitles.

(ii) AMCs shuld not be permitted to undertake any other business activity except mutual funds.

(iii) One AMC cannot act as the AMC for another mutual fund.

(C) Schemes

(i) Each scheme of a mutual fund must be compulsorily registered with the SEBI before it is floated in the market.

(ii) The minimum size of the fund should be Rs.20 crores in the case of each closed-end scheme and it is Rs.50 crores for each open-end scheme.

(iii) Closed-end schemes should not be kept opened for subscription for more than 45 days. For open-end scheme, the first 45 days should be considered for determining the target figure or the minimum size.

(iv) If the minimum amount or 60 per cent of the targeted amount, whichever is higher, is not raised, then, the entire subscription has to be refunded to the investors.

(v) To provide continuous liquidity, closed-end schemes should be listed on stock exchanges. In the case of open-end schemes, mutual funds shall sell and re-purchase units at pre-determined prices based on the Net Asset Value and such prices should be published at least once in a week.

(vi) For each scheme, there should be a separate and responsible fund manager.

(D) Investment Norms

(i) Mutual funds should invest only in transferable securities either in the capital market or money market or securitised debt. It cannot exceed 10 per cent in the case of growth funds and 40 per cent in the case of income funds.

(ii) The mutual fund should not invest more than 5% of its corpus of any scheme in any one company's shares.

(iii) This list of 5 % can be extended to10 % if all the schemes of a mutual fund are taken together.

(iv) No scheme should invest if any other scheme under the same AMC.

(v) No mutual fund under all its schemes take together can invest more than 15 per cent of the funds in the shares and debentures of any specific industry, except in the case of those schemes which are specifically floated for investment in one or more specified industries.

(E) Expenses

(i) The AMC may charge the mutual fund with investment management and advisory fees. Such fees should have been disclose in the prospectus.

(ii) The initial issue expenses should not exceed 6% of the funds raised under each scheme.

(iii) Excepting the initial issue expenses, all other expenses to be charged to the fund should not exceed 3% of the weekly average net assets outstanding during the current year. It must be disclosed through advertisements, accounts etc.

(F) Income Distribution

All mutual funds must distribute a minimum of 90% of their profits in any given year.

(G) Disclosure and Reporting

(i) The SEBI is given wide powers to call for any information regarding the operation of mutual funds and any of its schemes from the mutual fund or any person associated with it like the AMC, Trustee, Sponsor etc.

(ii) Every mutual fund is required to send its copies of duly audited annual statements of accounts, six monthly unaudited accounts, quarterly statements of movements in net assets for each of its schemes to the SEBI.

(iii) The SEBI, can lay down the accounting policies, the format and contents of financial statements and other reports.

(iv) The SEBI shall also lay down a common advertising code for all mutual funds to comply with.

Accounting Norm

(i) All mutual funds should segregate their earnings as current income, short term capital gains and long term capital gains.

(ii) Accounting for all the schemes must be done for the same year-ending

(I) Winding Up

(i) Each closed-end scheme should be wound up or extended with the permission of the SEBI as soon as the predetermined period is over.

(ii) An open-end scheme shall be wound up, if the total number of units outstanding after repurchases at a point of time falls below 50% of the originally issued number of units.

(J) Violation of Guidelines

The SEBI can, after due investigation, impose penalties on mutual funds for violating the guidelines as may be necessary.

6.12 MUTUAL FUNDS 2000

During April 1996, the Mutual Funds Department of SEBI has released an exhaustive study on the mutual fund industry called “Mutual Funds 2000”. The study has suggested several reforms as given hereunder :

(i) It has been proposed that mutual funds should broaden their areas of investment. Accordingly, there is a proposal to set up mutual funds to invest in quilt edged securities or real estate.

(ii) There is a proposal to do away with the restriction of a maximum industry exposure of 15% for a mutual fund scheme. Earlier this restriction applied to all Mutual Fund Schemes except those which are designed to invest in a particular industry.

(iii) At present, a mutual fund can hold at a maximum of only 5% of the equity of a company. It has been proposed that this limit be increased to 10%.

(iv) Similarly, it is proposed to remove the existing maximum limit of 10% of a mutual fund investment (both equity and debt) in a single company.

(v) All closed-end mutual funds should get used within 6 months from the date of allotment unless they offer a continuous repurchase facility to their clients.

(vi) It has been proposed that closed-end mutual fund schemes which offer monthly income or schemes which are targeted at any certain categories of investors like women need not get listed.

(vii) The existing requirement of minimum initial corpus for both open-end and closed-end schemes is likely to be removed.

(viii) Further, the requirement of refunding subscription in case of collection falling below 60% of the target collection is sought to be removed.

(ix) There is a proposal to extend the lock in period of 60 days before redemption in the case of open-end schemes to 6 months.

(x) For the purpose of meeting the redemption requests alone, it has been suggested that mutual funds be permitted to borrow upto 10% of their net assets for a maximum period of 3 months only.

6.13 SELECTION OF A FUND

Mutual funds are not magic institutions which can bring treasure to the millions of their investors within a short span of time. All funds are equal to start with. But in due course of time, some excel the other. It all depends upon the efficiency with which the fund is being managed by the professionals of the fund. Hence, the investor has to be very careful in selecting a fund. He must take into account the following factors for evaluating the performance of any fund and then finally decide the one he has to choose :

(i) Objective of Fund

First of all, he must see the objective of the fund-whether income oriented or growth oriented. Income oriented are backed mainly by fixed interest yielding securities like debentures and bonds whereas growth oriented are backed by equities. It is obvious that growth oriented schemes are more risky than income oriented schemes, and hence, the returns from such schemes are not comparable with each other. The investor should compare the particular scheme of one fund with the same scheme of another fund and make a comparative analysis. His objective should also coincide with the objective of the scheme which he proposes to choose.

(ii) Consistency of Performance

A mutual fund is always intended to give steady long term returns, and hence, the investor should measure the performance of a fund over a period of at least three years. Investors are satisfied with a fund that shows a steady and consistent performance than a fund which performs superbly in one year and then fails in the next year. Consistency in performance is a good indicator of its investment expertise.

(iii) Historical Background

The success of any fund depends upon the competence of the management, its integrity, periodicity and experience. The fund’s integrity should be above suspicion. A

good historical record could be a better horse to bet on than new funds. It is in accordance with the maxim “A known devil is better than an unknown angel.”

(iv) Cost of Operation

Mutual Funds seek to do a better job of the investible funds at a lower cost than the individuals could do for themselves. Hence, the prospective investor should scrutinize the expense ratio of the fund and compare it with other. Higher the ratio, lower will be the actual returns to the investor.

(v) Capacity for Innovation

The efficiency of a fund manager can be tested by means of the innovative schemes he has introduced in the market so as to meet the diverse needs of investors. An innovator will be a always a successful man. It is quite natural that an investor will look for funds which are capable of introducing innovations in the financial market.

(vi) Investor Servicing

The most important factor to be considered is prompt and efficient servicing. Services like quick response to investor queries, prompt dispatch of unit certificates. quick transfer of units, immediate encashment of units etc. will go a long way in creating a lasting impression in the minds of investors.

(vii) Market Trends

Traditionally it has been found that the stock market index and the inflation rate tend to move in the same direction whereas the interest rates and the stock market index tend to move in the opposite direction. This sets the time for the investor to enter into fund and come out of it. A prudent investor must keep his eyes on the stock market index, interest rate and the inflation rate. Of course, there is so scientific reasoning behind it.

(viii) Transparency of the Fund Management

Again, the success of a mutual fund depends to a large extent on the transparency of the fund management. In these days of investor awareness, it is very vital that the fund should disclose the complete details regarding the operation of the fund. It will go a long way in crating a lasting impression in the minds of the investors to patronize the fund for ever.

In fact, the wider range of products/services offered by the different funds, have made the investor quality-conscious. He is now in a position to assess the quality of the products offered by MFs in the financial market. MFs cannot simply attract savings by mere lucrative advertisements. The cult of the equity has spread to many small investors who have become very discerning in selecting mutual funds.

6.14 COMMERCIAL BANKS AND MUTUAL FUNDS

With a view to providing wider choice to small investors, the Government of India has permitted the banks to launch mutual funds as subsidiaries. There has been an urgent need for the banks to enter into the filed of mutual funds due to the following reasons:

(i) Banks are not able to provide better yields to the investing public with their savings and fixed deposit interest rates whereas many financial intermediaries, with innovative market instruments offering very attractive returns, have entered the financial market. So banks are not able to compete with them in tapping the savings. Hence there is a necessity to enter into the field of MFs.

(ii) The Gross Domestic Savings has risen from 10% in fifties to 20% in eighties, thanks to the massive branch expansion programme of banks and their growing deposit mobilization. Since the banks have branches in the rural as well as urban sectors, they can reach out to everyone in the country.

Hence, a MF backed by a bank will be in a better position to tap the savings effectively and vigorously for the capital market.

(iii) Indian investors, particularly small and medium ones, are not very keen in investing any substantial amount directly in capital market instruments. They may also hesitate to invest in an indirect way through private financial intermediaries. On the other hand, if such intermediary has the backing of a bank, investors may have confidence and come forward to invest. Thus, banks have the advantage of public confidence which is very essential for the success of mutual funds.

(iv) Earlier banks were not permitted to tap the capital market for funds or to invest their funds in the market. Now, a green signal has been given to them enter into this market and reap the maximum benefits.

(v) Banks can provide a wider range of products/services in mutual funds by introducing innovative schemes and extend their professionalism to the mutual funds industry.

(vi) Banks, as merchant banks have wide experience in the capital market and hence managing a mutual fund may not be a big problem for them.

(vii) The entry of banks would provide much needed competition in the mutual fund industry which has been hitherto monopolized by the U.T.I. This competition will improve customer service and widen customer choice also.

(viii) In the Indian economy, the eighties witnessed the operation of both the process of intermediation and dis-intermediation. The dis-intermediation process can be easily harnessed by commercial banks through mutual funds. The process of dis-intermediation of time deposits into mutual funds would benefit the capital market because it would provide a sustainable domestic source of demand.

(ix) Above all, the investor servicing can be effectively done by banks through their network of branches spread throughout the country. Hence, the

commercial banks have entered into the mutual fund market without any hesitancy.

(x) Moreover, the profitability of banks has been very much affected due to too many restrictions on their lending policies. They have been compelled to seek some other alternatives to increase their profits by means of diversifying their activities. Mutual Funds offer an excellent outlet for diversification.

6.15 MUTUAL FUNDS ABROAD

The mutual funds have been growing at an unprecedented pace throughout the world. In the USA, mutual funds have been labeled as the 'bank deposits of 1990s'. Mutual Funds have changed the American financial landscape by offering a menu of investment choice and some companies like Fidelity Investment, Vanguard and Merrill Lynch are very popular among them. The American have been pouring in over $1 billion every day into these funds. In the US today, nearly 83 million investors forming 27% of the households save in above 5000 funds. In fact the number of mutual funds outnumber the number of listed companies on the New York Stock Exchange. This industry has an annual growth of about 20 to 25 per cent.

The Funds in U.K. have already crossed the 1000 mark by the end of 1987. The top 25 funds in term of performance come from Japan and the Far East growth sectors. Some of them have doubled their money within a period of just one year. In Australia also, these fund have been very successful particularly on account of 46.8% rise to Australian All Shares Index. MFs are growing in size and importance in countries like Hong Kong, Singapore, Philippines, Thailand, South Korea etc.

6.16 MUTUAL FUNDS IN INDIA

In India, the Mutual Fund industry has been monopolized by the Unit Trust of India ever since 1963. Now, the commercial banks like the State bank of India, Canara

Bank, Indian Bank, Bank of India and the Punjab National Bank have entered into the field. To add to the list are the LIC of India and the private sector banks and other financial institutions. These institutions have successfully launched a variety of schemes to meet the diverse needs of millions of small investors. The Unit Trust of India has introduced huge portfolio of schemes like Unit 64, Mastergain, Mastershare, etc. It is the country's largest mutual fund company withover 25 million investors and a corpus exceeding Rs.55,000 crores, accounting for nearly 10% of the country's stock market capitalization. The total corpus of the 13 other mutual funds in the country is less than Rs.15,000 crore. The SBI fund has a corpus of Rs.2925 crore deployed in its 16 schemes servicing over 2.5 million shareholders.

There are also mutual funds with investments sourced abroad called 'Offshore Funds'. They have been established for attracting NRI investments to the capital market in India. The India Fund unit scheme 1986 traded in the London Stock Exchange and the India Fund Unit Scheme 1988 traded in the New York Stock Exchange were floated by the Unit Trust of India and 'the India Magnum Fund' was floated by the State Bank of India. At present, there are more than 15 different offshore Indian funds which have brought about $2.7 billion to the Indian market.

Besides this, the LIC and the GIC have also entered into the market. Again many private organizations have entered into the filed. Most of the schemes have declared a dividend ranging between 13.5% and 17%. In most of the cases it is around 14% only. The private sector which entered the arena in 1993 is concentrating on the primary market. It is so because, investments in new shares fetch appreciation between 30 and 1500 per cent in a very short period. Promoters too give preferential treatment to mutual funds because it reduces their marketing cost. Again, they go for fund-participation in a venture even before it goes public. They see potential for immense appreciation in unlisted securities which intended to go to public with a short period of one year.

In India, mutual funds have been preferred as an avenue for investment by the household savers only from 1990s. The sales of units of UTI which were Rs.890 crores in

1985-86 rose to Rs.4100 crores in1990-91 and Rs.9500 crores in1993-94. The public sector mutual funds were able to collect Rs.3800 crores in 1990-91. However, they could collect only Rs.400 crores in 1993-94. The private sector mutual funds mobilized Rs.1700 crores in1993-94. On the whole, the mutual fund industry was above to mobilize approximately Rs.12000 crores in 1993-94 which amounts to 8% of the gross domestic householding savings in the country. It is a good going indeed. However, the rate of growth is comparatively slow and not very satisfactory.

6.17 REASONS FOR SLOW GROWTH

Of late, mutual funds find their going very tough. Most of the funds are not able to collect the targetted amount from small investors. Investors tend to keep out of the new issue mutual funds and they prefer to buy units from the secondary market even by paying a brokerage fee of 3 per cent. The mutual fund industry has to face many problems also. Some of them are :

(i) Disparity Between NAV and Listed Price

Small investors are really bewildered at the lack of proper pricing for their units. Though the NAV seems to be good, the listed prices are awfully poor. Of course, the NAV is used as a parameter to rate the performance of the mutual funds. However, in practice, almost all the mutual fund schemes are deeply discounted to their NAV by as much as 30 to 40 per cent. Thus, the real dilemma for the investor is this disparity between the NAV and the listed price. Due to this factor, investors are not able to dispose off their units in the market and hence there is no liquidity at all.

(ii) No Uniformity in the Calculation of NAV

It is interesting to note that there is no standard formula for the calculation of the NAV. With the result, different companies apply different formula, and hence, any fruitful comparison of one fund with another is not at all possible. Hence, small investors cannot form a concrete opinion on the performance of different funds.

(iii) Lack of Transparency

Mutual funds in India are not providing adequate information and materials to the investors. It was expected that they would provide a detailed investment pattern of their various schemes. They would also have frequent and continuing communications with the unit-holders Unfortunately, most of the funds are not able to send even quarterly report to their members. For the success of mutual funds it is very essential that they should create a good rapport with the investors by declaring their entire holdings to them.

(iv) Poor Investor Servicing

Mutual Funds have failed to build up investor-confidence by rendering poor services. Due to the recurring transfer problems and non-receipt of dividend in time, people are hesitant to touch the mutual fund script. Instances are there where people have to wait for more than six months to get their unit certificates. Again, the percentages of units under objection with the funds is also very high ranging between 3 per cent and 10 per cent. It is also said that the fake certificates are also very high. This deteriorated after-sales service to the investors has positively affected the growth of this industry. Many investors have been driven out of this mutual fund industry due to this poor servicing. In the case of a company, there is a statutory obligation to convene the meeting of the shareholders and place before them important matters for discussion. there is no such meeting in the case of a mutual fund company.

(v) Too much Dependence on outside Agencies

In India, most of the funds depend upon outside agencies to collect data and to do research. There is no doubt that research-driven funds can ensure good returns to its members. But, one should not rely on borrowed research. Since research involves a lot of money, mutual funds think that their overhead cost will go up and thereby their administrative expenses will go beyond the 3 per cent level fixed by the SEBI. In practice it may not be so. Infact, they have to pay more for borrowed research and even that

cannot be fully relied upon. Unless they set up their own research cell, they cannot succeed in the business.

(vi) Investor's Psychology

Investors often compare units with that of shares and expect a high listing price. They don't realize that unit is a low-risk long term instrument. Indeed, mutual funds are only for those who have the patience to wait for a long period say 3 to 5 years. But, in practice, people don't have the patience. Hence, units are not popular among the public.

(vii) Absence of Qualified Sales Force

Efficient management of a fund requires expertised knowledge in portfolio management and skill in execution. Without professional agents and intermediaries, it cannot be managed efficiently. Unfortunately such professional people are rare. One can find a network of qualified broker to deal in shares and stocks. Such persons are conspicuously absent in the mutual fund industry and this absence of large and qualified sales force makes the industry suffer a set back.

(viii) Other Reasons

Few funds which have not performed well have actually demoralized the investing public. Moreover, the listing of close ended funds on the stock exchanges has compelled the medium and small investors to go back to the stock market and face the hassels and headaches of its dealing. Above all, there is a lack of investor education in the country. Most of the investors are not aware of the mutual fund industry and the various products offered by it.

6.18 MUTUAL FUNDS FOR WHOM?

These funds can survive and thrive only if they can live upto the hopes and trust of their individual members. These hopes and trust echo the peculiarities which support the emergence and growth of such institutions irrespective of the nature of economy where

these are to operate. Mutual funds come to the rescue of those people who do not excel at stock market due to certain mistakes they commit which can be minimized with mutual funds. Such mistakes can be lack of sound investment strategies, unreasonable expectations of making money, untimely decisions of investing or disinvesting, acting on advise given by others, putting all their eggs in one basket i.e. failure to diversify. Mutual funds come to the rescue of such investors who face following constraints while making direct investments :

i) Limited resources in the hands of investors quite often take them away from stock market transactions.

ii) Lack of funds forbids investors to have a balanced and diversified portfolio.

iii) Lack of professional knowledge associated with investment business enables investors to operate gainfully in the market. Small investors can hardly afford to have expensive investment consultations.

iv) To buy shares, investors have to engage share brokers who are the members of the stock exchange and have to pay their broker age.

v) They hardly have access to price sensitive information in time.

vii) It is difficult for him to know the developments taking place in share market and corporate sector.

vii) Firm allotments are not possible for small investors when there is a trend of over-subscription to public issues.

6.19 SUMMARY

Mutual Funds are trusts that pool the savings of innumerable small investors for the purpose of making investment in various financial instruments, capital market and money market, with a view of providing a reasonable return. Mutual funds offer the advantage of convenient savings and an ideal avenue for investment of small savings. Mutual Funds provide the benefit of professional management, besides a diversified investment opportunity. Further, mutual funds offer wide range of products to suit the

requirements of a wide spectrum of investors. Important among them include open and close ended schemes, income fund schemes, growth fund schemes, equity fund schemes, bond fund schemes, gilt funds, index funds, etc. The operational efficiency of a mutual fund can be judged by the NAV of the fund.

6.20 KEYWORDS

Mutual Fund: A trust that pools the savings of invests who share a common financial goal is known as Mutual Fund.

Open-ended Scheme: When a fund is accepted and liquidates on a continuous basis by a mutual fund manager, it is call open-ended scheme.

Net Asset Value: The intrinsic value of a unit under a particular scheme is referred to as the Net Asset Value of the scheme.

Growth Fund: A mutual fund whose primary objective is long term growth of capital.

Index Fund: A mutual fund that seeks to mirror general stock market performance by matching its portfolio to a broad based index is known as index fund.

6.21 SELF ASSESSMENT QUESTIONS

1. Define mutual fund. What are the risks associated with mutual funds?
2. “Mutual funds provide stability to share prices, safety to investors and resources to prospective entrepreneurs.” Discuss.
3. What rights and facilities are available to an investor of a mutual fund? What factors should be considered before selecting a mutual fund?
4. To what extent commercial banks in India are better fitted to take up the mutual fund business? What problems do they encounter in this direction.
5. What is Net Asset Value? How is it computed?

6.22 SUGGESTED READINGS

Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

Chandra, P., Financial Management, Tata McGraw Hill, New Delhi.

Khan, M.Y., Financial Services, Tata McGraw Hill, New Delhi.

Kothari, C.R., Investment Banking and Customer Service, Arihand Publishers, Jaipur.

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Subject	**:**	**Management of Financial Services**		

LESSON-7
MERCHANT BANKING

STRUCTURE

7.0 Objective

7.1 Introduction

7.2 Concept and Nature of Merchant Banking

7.3 Functions of Merchant Banker

7.4 Merchant Banking Regulations

7.5 Parameters of Evaluating a Merchant Banker

7.6 Features of Merchant Banking in India

7.7 Summary

7.8 Keywords

7.9 Self Assessment Questions

7.10 Suggested Readings

7.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Understand the concept of merchant banking.

(b) Explain the functions of merchant bankers.

(c) Discuss the features of merchant banking in India.

7.1 INTRODUCTION

Financial Service is rendered through numerous intermediaries who are known by different names. One of the prominent intermediaries is known as merchant banker. Their scope of operation differs from country to country. *Merchant banking* as it is known in present days had its origin in U.K and U.S.A in early fifties. But the roots of this service rendering industry can be traced as back as in late eighteenth century and early nineteenth century. There were merchants, who traded overseas, built reputation and later shared their goodwill with newer traders to facilitate their merchant activities especially by providing guarantees for payments. Subsequently they entered any field which added to their business depending on the demand of time. Thus, as time changed their role changed, consequently it has never been possible to pinpoint their role. As Sir Edward Reid of Baring Brothers & Co. commented, it is (merchant banking) sometimes applied to banks which are not merchants, merchants who are not banks and sometimes to houses who are neither merchants nor banks." Report of the Committee on the Working of Monetary System (1961) observed that origin of merchant bankers is associated with a variety of financial services including accepting. This is why merchant bankers are popular as 'issue houses' or 'accepting houses' in U.K. In U.S.A investment bankers have been performing the task being performed by merchant bankers elsewhere. Whether these are called accepting house or investment banker or merchant bankers, their common object is to facilitate trade and industry. Meeting their diverse and dynamic needs with the change in time and complexities in business has always been a challenge for merchant banking.

7.2 CONCEPT AND NATURE OF MERCHANT BANKING

Despite the fact that merchant banking is emerging as one of the prominent segment of financial service sector, it is difficult to define what merchant banking is. The reason is very obvious as its limits have never been adequately and strictly defined and it caters to wide variety of financial activities. Dictionary of Banking and Finance explains merchant bank as an organisation that underwrites securities for corporations, advises

such clients on mergers and is involved in the ownership of commercial ventures. Securities and Exchange Board of India (Merchant Bankers) Rules 1992 defines merchant bankers as “any person who is engaged in the business of issue management either by making arrangement regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management. The Guidelines for Merchant Bankers (issued by Ministry of Finance, Deptt. of Economic Affairs, Stock Exchange Division on 9-4-1990) instead of defining merchant banking stated that these guidelines shall apply to those presently engaged in merchant banking activity including as managers to issue and undertakes authorised activities. These activities interalia include underwriting, portfolio management etc. Thus. to defines merchant bankers a definite better approach is to include those agencies as merchant bankers which do what a merchant banker does.

To understand nature of merchant banking well, a contrast may be involved, between commercial banking and merchant banking. Although the terms 'Merchant' and 'Commercial' have similar connotations yet commercial banking and merchant banking are different. Commercial bankers are basically a financing agency where as merchant banks provide basically financial (not financing) services. Commercial bankers are comparatively retail banking activity where as merchant banking is a whole sale banking (even if it provides financing services also). A merchant banking firm does not undertake commercial banking where as its, reverse is possible. Commercial banking involves collections of savings and putting it, to optimum use as per plans and guidelines where as merchant banking refers to just an agency facilitating transfer capital from those who own to those who can use it without handling the amount of its own. Merchant bankers is more of an intermediary. In the same context a merchant bank can be distinguished from a development bank since the latter is more involved in fund raising and lending. Like commercial banks, development banks may also have separate merchant banking division.

7.3 FUNCTIONS OF MERCHANT BANKER

Setting up of new industrial units, expansion, diversification and modernisation of existing units have been the central plank of the rapid industrialisation in any economy. This process besides adequate financial resources requires sound technical and managerial inputs. Though, a number of financial agencies are instituted to cater to the needs of rapid industrialisation, the task of financing has become more complicated, thus requiring a fresh look. In view of increasing specialisation in every sphere the process of industrialisation from the primary planning stages of setting up a new unit to that of research and development including expansion, diversification or modernisation requires the services of specialists or professionals. Thus, the need for having expert advice, guidance of specialists or professionals in the field has become an absolute necessity with rapid economic growth and spectacular industrial development in India. It has also been necessitated by the plethora of regulations for industry, capital, issues, foreign investment and collaboration, amalgamations, Companies Act, SEBI, Government policy regarding backward area development, export promotion and import substitution etc. A few agencies are able to provide expert advice in the diversified areas mentioned above. But it is inconvenient to entrepreneurs industrialists to knock at the doors of several agencies in getting the guidance of specialists and professionals. Hence, it is highly essential to provide expert advice in diversified areas under a single roof to provide a comfortable cushion to entrepreneurs to accelerate industrial development. This is where merchant bankers come to picture. Although is it is very difficult to spellout all the areas where merchant bankers can interact, yet, some important areas where merchant bankers have decisive role are discussed here. These role can broadly be divided into two parts. One is service based another is fund based.

A. Service based Functions

i) Project counselling

The first step to launch a business unit is selection of a viable project. Merchant bankers undertake this assignment on a very large scale since they have experts with them in diverse fields. Project counselling covers a variety of sub assignments. Illustrative list of services which can be rendered under this category is :

- Guidance in relation to project viability i.e. project identification and counselling. It may be for setting up new units, expansion or improvement of existing facilities.
- Selection of consultants for preparation of project reports/market surveys etc. Sometimes merchant bankers also engage in preparation of project reports or market surveys.
- Advice on various procedural steps including obtaining of governmental approvals clearance etc. e.g. for foreign collaboration.
- Proposing a suitable capital structure laying broad as well as specific features.
- Teachno- economic soundness of the project and marketing aspects. Financial engineering i.e. selection of right mix of financing pattern specifically for short term requirements.
- Organisation and management set up for a strong base and efficient working of the project.

ii) Credit syndication

Normally every project has to raise debt funds for different sources as per need. Substantial debt raising may be required for a new and capital intensive project. For such project merchant bankers may undertake credit syndication. Credit syndication is credit procurement service. As per the requirements, such syndication can be from national as well as international sources. Some of the important credit syndication services offered are.

- Preparing applications for financial assistance to be submitted to financial institutions and banks.
- Monitoring the sanction of funds while acting as a specialised liaison agency.
- Negotiating the term of assistance on behalf of client.
- Post sanction formalities with these institutions and banks.
- Assistance in drawl of term loans and or bridging loans.
- Assessing working capital requirements and arranging it.

Need of syndication arises due to the fact that specially in big projects one institution may hesitate to meet the whole debt requirement of the project. They want to spread the risk. Further shortage of funds availability with one lender also requires credit syndication. The merchant banker by rendering credit syndication services saves the time of the borrower.

The modus operandi of a syndication is really quite simple. The borrower approaches several banks which might be willing to syndicate a loan, specifying the amount and the tenor for which loan is to be syndicated. On receiving a query, the syndicator scouts for banks who may be willing to participate in the syndicate. Based on an informal survey, it communicates its desire to syndicate the loan at an indicative price to the corporate borrower, all in a matter of days. After reviewing the bids from various banks, the borrower awards the mandate to the bank that offers him the best terms.

The syndicator, on his part, can underscore his willingness to syndicate the loan on a firm commitment basis or on a best-efforts basis. The former is akin to underwriting and will attract capital adequacy requirements. That may reduce the bank's flexibility. "In India, given the fact that banks may not be willing to maintain capital in the interim period, most syndicates the likely to be done on a best-efforts basis."

Best-efforts, as the name suggests, limits the obligation of the syndicator, as he is not compelled to provide the loan on his own, in case he fails to arrange the loan.

However, more often than not, the syndicator would try to fulfill his commitments for the inability to do so would tarnish his reputation. Once the syndicator has been awarded a mandate, the borrower has to sign a 'clear market clause' which stops him from seeking a syndicated loan from any other bank, till such time as the documentation for the syndication is drawn up by the syndicate manager. This may take about three-four weeks.

In the interim period, the syndicate manager gets the banks to agree to syndicating the loan. It can do this on a 'broadcast' basis, by sending taxes to the concerned banks inviting participation. If the company is well known, the loan uncomplicated and the market liquid, such a method would work well. However, if the corporate tends to keep a low profile and the loan structure is complicated, the syndicate manager would have to woo the participant banks with offer documents or an information memorandum on the company. The document is similar to a prospects but less detailed. Nevertheless drawing up such a document does call for a lot of homework. The syndicate manager has to be very careful because he can be held responsible for any inaccuracy or omission of material facts.

The participants, after reviewing the prospects, decide whether or not to join the syndicate. However, given the fact that most of the participants may be smaller Indian banks, they may take weeks to give the final nod. Once the bank decides to become a member of the syndicate, it indicates the amount and the price that it is likely to charge on the loan. Based on information received from all participants, the syndicate manager prepares a common document to be signed by all the members of the syndicate and the borrowing company. The document usually lists out details of the agreement with regard to tenor, interest prepayment clause, security, covenants, warranties and agency clause.

iii) Issue management

Traditionally this is one of the main functions of merchant banker. When ever an issue is made whether it is public issue or private placement and further whether it is for equity shares, preference shares or debentures, the merchant banker has a crucial role to play. Raising of funds from public has many dimensions and formalities which are not

possible for the concerned. companies to comply with, where merchant banker comes to their rescue. Marketing effort to convince the prospective investor needs special attention. Here again merchant bankers are specialists. The specific important activities related to issue management performed by merchant banks are mentioned here:

- Advise the company about the quantum and terms of raising funds.
- Advise as to what type of security may be acceptable in the market as well as to the concerned lending institutions at the time of issue.
- Advise as to whether a fresh issue to be made or right issue to be made or if both, then in what proportion, obtaining the desired consents, if any, from government or other authorities.
- Advice on the appointment of bankers, brokers to the issue.
- Advice on the selection of issue house or Registrar to the issue, printer advertising agency etc.
- Fixing the terms of the agencies engaged to facilitate making a public issue.
- Preparation of a complete action plan and budget for total expenses of the issue.
- Drafting of documents like prospectus, letter of offer and getting approval from concerned agencies.
- Assisting in advertisement campaigns, holding the press, brokers' and investors' conferences etc. for grooming the issue.
- Advise the company for the issue period and days of opening and closing the issue.
- Monitoring the collection of funds in public issue.
- Coordination with underwriters, brokers and bankers to the issue and stock exchange etc.
- Strict compliance of post issue activities.

iv) Corporate counselling

Although the functions discussed up till now are also covered under corporate counselling but here other dimensions will be deliberated. Corporate counselling is to rejuvenate the corporate units which are otherwise having signals to low productivity, low efficiency and low profitability. The merchant bankers can play a substantial role in reviving the sick units. They make mergers and acquisition exercise smooth, They can advise on improvement in the systems operating in managing the show of a corporate unit. Some of the specific assignments for the merchant banker are:-

- Rejuvenating old line and ailing/sick unit or appraising their technology and process, assessing their requirements and. restructuring their capital base.
- Evolving rehabilitation programmes/packages which can be acceptable to the financial institutions and banks.
- Assisting in obtaining approvals from Board for Industrial and Financial Reconstruction (BlFR) and other authorities under the Sick Industrial Companies (special provisions) Act1985 (SICA).
- Monitoring implementation of schemes of rehabilitation.
- Advice on financial restructuring involving redeployment of corporate assets to refocus companies line of business.
- Advice on rearranging the portfolio of business assets through acquisition etc.
- Assisting in valuing the assets and liabilities.
- Identifying potential buyers for disposal of assets if required. Identify the candidates for take over.
- Advice on tactics in approaching potential acquisition.
- Assisting in deciding the mode of acquisition whether friendly or unfriendly or hostile.

- Designing the transaction to reap the maximum tax advantages. Acting as an agent for leveraged buyout (LBO) involving heavy use of borrowed funds to purchase a company or division of a company.
- Facilitating Management Buy outs (MBO) i.e selling a part of business to their own managers by a company.
- Clearly spelling out organisation goals.
- Evolving corporate strategies to achieve the laid down goals.
- Designing or restructuring the organisational pattern and size.
- Evolving Management Information System.

Corporate advisory services should offer real value addition to the client. Highly specialised in nature, these services should be clearly distinguished from the gamut of other financial services offered by NBFCs such as underwriting or fund-based activities of leasing and hire purchase. In India corporate advisory has a good potential. The Indian industry is going through an unprecedented churning, bracing itself for global competition. The Indian corporate sector has been on a restructuring spree. Groups have been shedding companies. Companies in turn, have been dropping divisions as they struggle to become fit to survive in the new milieu. Free pricing of issues and the opportunity to tap the international market through the Euro-issue route has greatly enhanced the need for expert advisory services. In areas of restructuring, strategic alliances and corporate planning is now advising foreign companies in their plans for development of infrastructure in India. Merchant bankers have a great role to play.

Strategic product consolidation is another recent phenomenon. Units in which the company does not plan to become a market leader are spun off to others. A good corporate advisor is always on the alert to seize such opportunities. The process of acquisition cannot be done overnight. It requires a patient search for the right company which can be acquired, the proper evaluation of the financial impact of the acquisition, a sound strategy in blending the business acquired within the fold of the group, followed by negotiation and execution of the agreement. Occasionally, advisory services are required

in cases of splits within the family group. In such cases, there is a need to split the company into different units amongst the disputing family members. At the same time, the shareholders interest is to be kept in mind by the corporate advisor.

v) Portfolio management

Merchant bankers as a body of professionally qualified persons also undertake assignments of managing an individual investor's portfolio. Portfolio management is being practised as an investment management counselling in which the investor is advised to seek financial assets like government securities, commercial papers, debentures, shares, warrants etc. that would grow in value and/or provide income. The investors whether local or foreigner with substantial amount for investment in securities seek portfolio management services of authorised merchant bankers. The functioning of portfolio manager can be regulated or unregulated. Portfolio manager may use totally his discretion or may act only after getting signal from investor for each transaction of sale or purchase. A diverse range of services which may be rendered by merchant banker include: -

- Advising what and when to sell and buy.
- Arranging sale or purchase of securities.
- Communicating changes in investment market to the client investor
- Compliance of regulations of different regulating bodies for sale of purchase of portfolio.
- Collection of returns and reinvest as per directions of clients.
- Evaluating the portfolio at regular intervals or at direction of investors.
- Advising on tax matters pertaining to income from and investment in portfolio
- Safe custody of securities.

vi) Stock broking and dealership

The merchant bankers who have requisite professional knowledge and experience may also act as share broker on a stock exchange and even as dealer for Over The Counter trading. To venture into this area it is normally desired that the merchant banker has reasonable network. Their actions and activities are regulated by rules and regulations of the concerned stock exchange. They are at liberty to appoint sub brokers and sub dealers to ensure wider net work of their operations. They can be broker for inland as well as foreign stock exchanges. In India the merchant bankers who desire to act as brokers are regulated by SEBI (Stock Broker and Sub-brokers) Rules 1992.

vii) Joint venture abroad

Depending on economic and political considerations many countries may permit joint ventures by local businessmen abroad. Here again merchant bankers can play a decisive role. They facilitate meeting of foreign partner, get sanctions under various provisions, make techno economic surveys, legal documentations under local as well as foreign legal provisions etc.

viii) Debenture trusteeship

The merchant bankers can get themselves registered to act as trustee. These trustees are to protect the interests of debenture holders as per the terms laid down in trust deed. They are, as trustees, to undertake redressal of grievances of debenture holders. They are to ensure that refund monies are paid and debenture certificates are dispatched in accordance with the Companies Act. Debenture trustees are expected to observe high standards of integrity and fairness in discharging their functions. They can call for periodical reports from the body corporate. They charge fee for such services.

B. Fund based Functions

(i) Bill discunting

Bill discounting is a service against which merchant banker has to arrange funds against the bills which have been discounted. This service is undertaken by merchant bankers generally if bill market is big as well as mature. Otherwise bill discounting is undertaken by banks only. Depending on their credibility they may also undertake the assignment of bill acceptance. These bills accepted and or discounted can be foreign and merchant bankers can specify what types of bills they entertain. They charge commission for these services.

(ii) Venture capital

Venture capital is the organized financing of relatively new enterprises to achieve substantial capital gains. Such new companies are chosen because of their potential for considerable growth due to advance technology, new products or services or other valuable innovations. A high risk is implied in the term and is implicit in this type of investment. Since certain ingredients necessary for success of such projects are missing in the begging but are added later on. Merchant bankers undertake to arrange and if necessary, to provide such venture capital since traditional sources of finance like banks, financial institutions or public issue etc. may not be available. Since expected returns on projects involving venture capital is high, these are normally provided on soft terms. Such scheme is also popular as seed capital or risk capital scheme. Merchant bankers deeply study such proposals before releasing the money. At opportune time such investment can be disinvested to keep the cycle of venture capital more on.

(iii) Bought out deals

When a promoter envisages that if public issue made to raise capital will not clinch, he may approach merchant bankers (bought out dealer or sponsor) and places the shares of company initially with him which are offered to public at a later stage, this

route is known as bought out deal. Many a time a syndicate of merchant bankers jointly sponsor a bought out deal to spread the risk involved. In contract to venture capital, there is no role to be played by non traditional technology. Such bought shares by sponsor can be disposed off at an opportune time on 'over the counter' or other stock exchanges.

(iv) Lease financing and hire purchase

Depending on the funds available, merchant bankers can also enter the field of lease or hire purchase financing. Lease is an agreement where by the lessor (merchant banker in our case) conveys to the lessee (the user), in return for rent, the right to use an asset for an agreed period of time. On the other hand in hire purchase the user at the end of the agreed period has an option to purchase the asset which he has used till date. The merchant bankers can advise the client to go in for leasing or hire purchase system of financing an asset. A comparative study may be communicated to the prospective client showing benefits of these alternatives. The client can also depend on merchant banker for acquiring the needed asset and complying with all formalities.

(v) Factoring

Factoring is a novel financing innovation. It is a mixed service having financial as well as non financial aspects. On one hand it involves management and collection of books debts which arise in process of credit sale. The merchant bankers can take up this assignment and are required to perform activities like sales ledger administration, credit collection, credit protection, evolving credit policy, arranging letter of credit etc. On the other hand there is involvement of finance. Against factored debts the merchant banker may provide advance with a certain margin. The released funds can be used by client to manage its liquidity and working capital. Merchant bankers are entitled to service charges for factoring services. The merchant banker's role is thus to :

- Maintain the books of accounts pertaining to credit sales

- Make a systematic analysis of relevant information for credit monitoring and control.
- Provide full or partial protection against bad debts and accepting the risk of non realization.
- Provide financial assistance to the client.
- Provide information about prospective buyers.
- Provide financial counseling and assisting managing the liquidity.

vi) Underwriting

It refers to a contract by means of which merchant banker gives an assurance to the issuing company that the former would subscribe to the securities offered in the event of non-subscription by the persons to whom it was offered. The liability of merchant banker arises if the issue is not fully subscribed and this liability is restricted to the commitment extended by him. The merchant bankers undertaking underwriting make efforts on their own to induce the prospective investors to subscribe to the concerned issue. Such assignment is accepted after evaluating viz :

- Company’s standing and its past record.
- Competence of the management.
- Purpose of the issue.
- Potentials of the project being financed.
- Offer price and terms of the issue.
- Business environment.

The financial involvement of merchant banker in underwriting arises in case of development. To get their blocked funds released, the merchant bankers have stock exchange as exit route. They get underwriting commission.

These are some of the prominent activities being undertaken by merchant bankers world over. The practices may differ from country to country depending on maturity of

financial sector of their economy. The multifarious activities of the corporate sector and spectacular growth of industry gives new dimensions to merchant banking activities. In the phase of globalisation of economies merchant bankers are facing new challenges. The changing international financing environment has rather pushed merchant bankers to operate at international level creating more opportunities to serve the world business community in diverse ways.

7.4 MERCHANT BANKING REGULATIONS

SEBI (Merchant Bankers') Regulations 1992 define merchant banker as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management." Thus regulations are applicable only to limited activities undertaken by merchant banker. On the basis of regulations, merchant banking activities can be categorised as 'authorised' and 'not authorised' activities. The merchant bankers are required to get themselves registered under regulations only for authorized activities. The authorized activities are undertaking issue management assignment, as manager, consultant, adviser, underwriter port folio manager.

a) Merchant Banking Activities not requiring SEBI's registration are :

- Project Counselling
- Corporate Counselling
- Factoring
- Credit Rating
- Bill acceptance and discounting
- Loan syndication
- Merger and amalgamation

b) Merchant Banking Activities requiring SEBI's registration under different regulations but not under Merchant Banking regulations :

- Venture Capital
- Mutual Funds
- Depository
- Portfolio Management
- Trusteeship of debentures
- Share Broking
- Custodian Service
- Foreign Institution of Investor
- Share Transfer

Another angle from which authorized activities can be identified is the activities specified for each categories of merchant banker.

Categories of Merchant Bankers

The merchant banking regulations require that any body seeking registration as merchant banker has to apply in one of the following four categories :

Category I : These merchant bankers can carry on any activity of the issue management, which will *inter-alia* consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of subscription. They can also act as adviser, consultant, manager, underwriter, portfolio manager.

Category II : Such merchant bankers can act as adviser, consultant, co-manager, underwriter and portfolio manager. This means they can not undertake issue management of their own.

Category III : These merchant bankers can neither undertake issue management nor act as co-manager. They cannot conduct business of portfolio management. Thus the area of their operation restricts to act as underwriter, adviser and consultant to the issue.

Category IV : Such merchant bankers do not undertake any activities requiring funds. They can act only as adviser or consultant to an issue.

Registration

Any agency to operate as merchant banker has to register it self under SEBI Regulations. Application is to be submitted in the prescribed format. To get registration and certificate to operate as merchant banker, the agency has to fulfill two sets of criteria

(i) Operational capabilities.

(ii) Capital adequacy.

i) Operational capabilities : As mentioned earlier, the regulations desire the merchant banker to be professional, fair and competent to serve investors. In this context SEBI before granting 'certificate to operate as merchant banker' makes sure that concerned agency is competent on these parameters. To be more specific these are :

a) It is necessary that to serve the clients and investors the merchant banker should have sufficient physical infrastructure. It is desired that the applicant has the necessary infrastructure like adequate office space, equipments and manpower to effectively discharge his activities.

b) To ensure that services rendered are the best, SEBI desires the applicant to have atleast two persons who have the experience to conduct the business of the merchant banker.

(c) In order to avoid excessive registration SEBI makes sure that a person directly or indirectly connected with the applicant has not been already granted registration. Such persons include an associate, subsidiary, interconnected or group company of the applicant.

(d) The applicant or his partner or director should be man of integrity. SEBI requires that applicant or its main officials should not be involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant.

- They should not at any time be convicted for any offence involving mortal turpitude or has been found guilty of any economic offence.
- The applicant is to have professional qualification from any recognized institution.
- SEBI is to make sure that such registration should be in the interest of investors.

Only those applicants who qualify on all these points are granted registration.

(ii) Capital adequacy : In the categories where in fund based activities are involved, SEBI desires them to have sufficient capital. The concept of adequate capital is expressed in terms of 'net worth'. 'Net worth' means the value of capital contributed to the business plus free reserves. At the time of registration as well as subsequently following pattern of 'net worth' should be at least maintained :

Category of Merchant Banker	**Minimum Networth**
Category I	Rs. 5,00,00,000
Category II	Rs. 50,00,000
Category III	Rs. 20,00,000
Category IV	NIL

Those applicants who qualify on both fronts are granted registration. The registered applicants are granted certificate of registration in 'Form B' in which SEBI specifies for which category registration has been granted. If the applicant is granted a category lower than applied for, the applicant is free to approach SEBI for higher category but with in one year from date of such registration. When certificate is finally granted the registered merchant bankers are to submit required fees. Registration is

granted for three years at one time. To keep the registration operative, merchant bankers are to pay registration fee. The registration fee pattern is as under :

Category	**Fee for first two years**	**Third year**
Category I	Rs. 2.5 lakh per year	Rs. 1 lakh
Category II	Rs. 1.5 lakh per year	Rs. 0.5 lakh
Category III	Rs. 1 lakh per year	Rs. 0.25 lakh
Category IV	Rs. 5,000 per year	Rs. 1,000.

Once registration granted is about to expire, merchant bankers are to get this registration renewed. Application for such renewal is again to be made. To ensure that there is no break in registration, such application has to be made with in 3 months before the expiry of the certificate. Although it is termed as renewal, but application is processed as for new registration, that is why application is again made in 'Form A'. Once registration is renewed due fee is to be paid which is as under :

Category	**Fee for first two years**	**Third year**
Category I	Rs. 1 lakh per year	Rs. 0.2 lakh
Category II	Rs. 0.75 lakh per year	Rs. 0.1 lakh
Category III	Rs. 0.50 per year	Rs. 0.05 lakh
Category IV	Rs. 0.05 per year	Rs. 0.02 lakh

Code of Conduct

Once merchant bankers are registered to ensure that they maintain high standard of services, regulations require them to adhere to a code of conduct specified in the Schedule III of the Regulations while acting as merchant bankers. Some important provisions of code are as under :

- Maintain high standard of service.

- Exercise due diligence, ensure proper care and exercise independent professional judgement.
- Disclose to the clients, possible sources of conflicts of duties and interest while providing unbaised services.
- Conduct business observing high standard of integrity and fairness in all his dealings with clients and other merchant bankers.
- Maintain secrecy about client.
- Do no engage in unfair competition.
- Not to make misrepresentation.
- Provide true and adequate information to investors.
- Not to create false market or engage in price rigging.

Lead Manager

It is required under regulations that every issue should be managed by at least one merchant banker acting as 'lead manager'. Such lead manager is not required if :

- the issue is right issue.
- the size of issue is not exceeding rupees 50 lakh.

The merchant banker acting as lead manager must enter into an agreement with the concerned company. This agreement must state their mutual rights, liabilities and obligations relating to such issue. Agreement terms pertaining to particulars to disclosures, allotment and refund should be clearly defined, allocated and determined.

In bigger issues more than one lead managers can be appointed but their number is subject to norms laid down by SEBI.

	Size of issue	**Maximum number of led manager**
a)	Less than rupees fifty crore	Two
b)	Rupees 50 crore but less than Rs.100 crore.	Three

c)	Rs.100 crore but less than Rs.200 crore	Four
d)	Rs.200 crore but less than Rs.400 crore	Five
e)	Rs.400 crore and above	Five or more as agreed by SEBI

Duties of Merchant Banker/Lead Manager

a) In case more than one merchant bankers are engaged as lead manager, they have to clearly demark their duties and responsibilities. A statement of such division of job and responsibilities is to be furnished to SEBI at least one month before opening of the issue. Where the circumstances warrant joint and several responsibility of lead manager for a particular activity, a coordinator designated from among the lead managers shall furnish to SEBI with report, comments etc. on the matters relating to the joint responsibility. The activities where division is normally sought is on ‘pre-issue activities’ and ‘post issue activities’, SEBI requires that ‘post issue activities’ should be the responsibility of one lead manager. It involves essential follow up steps like finalisation of basis of allotment/weeding out multiple applications, listing of instrument, dispatch of certificates and refunds etc.

b) A merchant banker can not be a lead manager to an issue made by any body corporate which is an associate of the lead merchant banker.

c) A lead manager is not to associate with an issue if any merchant banker associated with the issue is not holder of certificate of registration.

d) A lead manager who is category I merchant banker has to accept a minimum underwriting obligation of 5 per cent of the total underwriting commitment or Rs.25 lakh which ever is less. This is to ensure his financial involvement in the issue.

e) It is his duty to submit SEBI a due diligence certificate in ‘Form C’. This is to ensure that the contents of the prospectus or letter of an offer are verified and are reasonable. This certificate is to reach at least two weeks prior to opening of an issue.

f) SEBI requires lead manager to submit specified documents like particulars to the issue, draft letter of offer or prospectus.

g) Lead manager to incorporate changes in prospectus etc. if desired by SEBI.

h) Lead manager has to continue as lead manager with the issue till the subscribers have received the certificates or refunds of excess money.

i) Merchant bankers are prohibited from entering into any transaction, directly or indirectly in securities on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment. It is referring to insider trading.

j) SEBI is to be informed, by merchant banker about the acquisition of securities of the boy corporate whose issue is being managed by the merchant banker, within 15 days from the date of entering into such transaction.

k) A merchant banker has to disclose to SEBI the following information :

   i) his responsibilities with regard to the management of the issue.

   ii) any change in the information or particulars previously furnished which have a bearing on the certificate granted to it.

   iii) the name of body corporate whose issues he has managed or has been associated with.

   iv) any default in capital adequacy requirements.

   v) his activities as a manager, underwriter, consultant or adviser to an issue as the case may be.

l) Every merchant banker shall keep and maintain the required books of accounts, records and documents like balance sheet, income statement, auditor's report, a statement of financial statement. Such records are to be maintained for 5 years. They are to submit half yearly unaudited financial results when required by SEBI with a view to monitor the capital adequacy of the merchant banker.

m) When SEBI initiates inspection of the said records, the merchant banker has to cooperate. SEBI shall give notice before inspection.

Liabilities of Merchant Bankers

Many provisions are incorporated in the MB Regulations to regulate the activities of merchant bankers. To make them more responsible and accountable SEBI has provisions to impose penalty in case of defaults by them. The merchant bankers are subject to penalty if they

a) fail to comply the conditions subject to which certificate has been granted

b) fail to comply with the provisions of the concerned rules and regulations

Two types of penalties can be imposed by SEBI on defaulting merchant bankers. One is suspension of registration and second is cancellation of registration.

a) Suspension of registration

Under the following circumstances the registration of a merchant is banker stands suspended when a merchant banker :

i) violates the provisions of the Act, rules and regulations and terms of registration

ii) fails to furnish required information to SEBI or provides false information

iii) fails to satisfy the investors and SEBI about the complaints of investors

iv) manipulates or rigs the price of securities

v) misconducts or adopts unprofessional practices

vi) fails to maintain required capital adequacy or pay the required fees

b) Cancellation of registration

In cases where there are grave misconducts or defaults, the registration of a merchant banker can even be cancelled. Some of such situations are where a merchant banker :

i) indulges in deliberate manipulation or price rigging or other activities against the interest of investors.

ii) fails to maintain satisfactory financial status which may lead to dilution in services to investors.

iii) involves in fraud or is convicted of a criminal offence

iv) indulges repeatedly in defaults resulting in suspension of registration.

In these regulations SEBI has deviated from the earlier penalty point system announced by SEBI in guidelines for merchant bankers in 1991. Defaults were categorized in four types, general default (Type I), minor defaults (Type II), major defaults (Type III) and serious defaults (Type IV). Penalty points are assigned to each type of defaults these being one, two, three and four respectively. The defaults in each type was specified specifically e.g.

a) non receipt of :

i) draft prospectus,

ii) inter-se allocation of responsibilities,

iii) due diligence certificate etc. constituted general default,

b) i) exaggerated information

ii) non compliance of advertisement code

iii) delay in refunds

iv) allotment of securities etc. constituted minor default,

c) i) failure to take mandatory underwriting,

ii) engaging more lead manager than warranted under guidelines

iii) association with unauthorized merchant banker etc. were termed as major defaults and

d) i) unethical practices

ii) violation of code of conduct

iii) non cooperaton with SEBI constituted serious defaults.

Any merchant banker reaching cumulative penalty points of ‘eight’ attracted action from SEBI.

7.5 PARAMETERS OF EVALUATING A MERCHANT BANKER

Merchant bankers can be evaluated by their clients (issuers or companies and investors) on two broad parameters discussed here :

i) Qualitative

If refers to those factors which hint at quality of service rendered by merchant banker. The most important feature here is quality of the staff with the merchant banker. The employed officials should be professionally qualified having expertise specially in finance, project evaluation, marketing, operation research. It is not sufficient to recruit professionals. Their knowledge should be up dated regularly so that they are near to international practices. To evaluate qualitative aspects, the merchant bankers can be judged on their ability to advise the clients on matters like capital structure, innovative instrument, ability to get clearances for client from different agencies, his association and rapport with other intermediaries like registration to the issue, bankers to the issue, underwriter etc. Even the investor evaluate the merchant banker because they will like to subscribe to the issues of only reliable merchant banker and this is more important in view of SEBI’s move not to vet prospectus for any issue. Features like what is the ability to evaluate promoters, techno-economic feasibility of projects and assessing the investor friendliness of the promoter matter for investors. Issuers also consider the ability of

merchant banker to be perfect market timer. Pricing strategy is an aspect which investor as well as issuer both should evaluate before having business with a merchant banker. To high price is a loss to investor and low prices are not appreciated by the issuers. Despite the specified disclosure requirements, investors depend more on merchant banker who has a practice of more and more and dependable disclosures. Concern of merchant banker for after issue services and investors protection is another parameter used by investors to evaluate merchant bankers.

(ii) Quantitative

The main parameter here is his statistics of activities undertaken like the number of issues handled, the amount of funds managed, the organizations which have been his client, the size of the issue handled etc. The statistics as to the issues being quoted at discount or at premium after handling the issues is very significant parameter. How many underwritings have been done and the amount involved in the process also indicate quality of merchant banker. A merchant banker with high net worth is generally considered to be efficient. How many professionals and other qualified staff members are associated also matters.

Merchant Banker's Environment

Merchant bankers rendering financing services are influenced by a number of factors. These factors also assist us assessing the quality of services rendered by them. These environmental components may continue to be the same but their impact is always likely to be dynamic. Investor's expectations increase as they become more aware and educated. Regulatory agencies go on amending their rules and regulations to discipline the merchant bankers. Such changes in regulations etc. may be more frequent till the time there is professional maturity. The fast development on technology front certainly improves the quality of services if adopted. Any one not changing as per technology is sure to lag behind. Innovations always pay in profession.

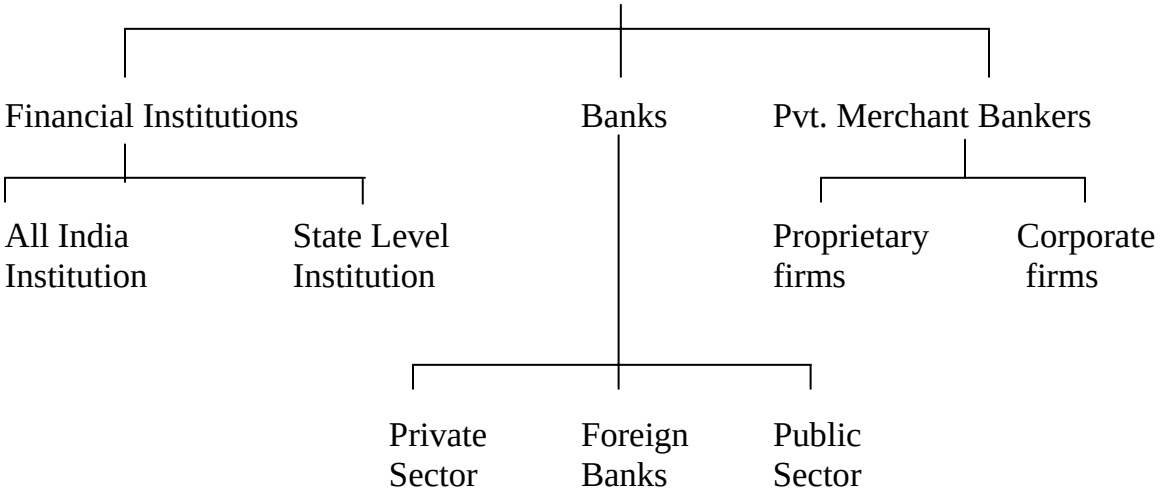
7.6 FEATURES OF MERCHANT BANKING IN INDIA

Types

Merchant banking in India has been given a specific direction by SEBI (Merchant Bankers) Regulation. Since their role in public issue is exchaustive and their responsibilities absolute, professional expertise is needed. Thus after SEBI, merchant bankers emerged from all segments of the economy. It was no longer a monopoly of institutional and banker merchant bankers. This is shown in Chart I.

Chart I

Merchant Bankers



In simple terms the merchant banking activity can be divded amongst four segments :

i) Institutions like IDBI, ICICI, IFCI floated merchant banking subsidiaries or divisions

ii) Foreign banks like Grindlays, Standard Chartered, Honkong Bank, City Bank launched merchant banking divisions

iii) Nationalised banks promoted subsidiaries to carry out merchant banking activities like SBI Caps, PNB Caps, Canfina

iv) Private sector merchant bankers like JM, Kotak Mahindra, DSP, Master Trust who were either brokers or underwriters or portfolio managers.

Registration

In a period of 2 years since SEBI took over merchant bankers, the primary market was in boom so there was a line of professionals to get themselves registered as merchant bankers. It was generally felt that the merchant banking profession being regulated, only competent and well equipped organizations should be granted such recognition to act as merchant bankers. However, it was strongly felt by a large number of professionals in merchant banking that SEBI's liberal grant of recognition might not augur well for long term growth of this specialised business. SEBI, on the contrary expressed a view that the large number of new players brought in a sense of competition to the profession and ultimately their success was dependent on how well they served their clientele. While SEBI had a strong rationale to support its viewpoint, many feel that this resulted in a general dilution in the quality of services. SEBI contemplated enhancing the minimum net worth requirement from Rs.10 million to Rs.25 million. In a nascent liberalized capital market environment, SEBI's task of regulating the intermediaries was certainly not very easy . Whatever critics might pointed out, the fact remained that SEBI instilled a lot of discipline into the market place.

As a result of unrestricted entry, over 350 Category I Merchant bankers got registered with SEBI till 1995. Assuming that each outfit had at least two other branch offices in India (most of them have over six branches), in effect there are 1,050 outfits. Even assuming that each outfit independently churned out three issues in a year (which is the bare minimum if one has to meet the expenses of running the office), there should have been over 3000 issues hitting the markets in a year or on an average 250 issues every months.

Quality of Service

Such keen competition for business led to a large number of merchant bankers compromising on quality and turning a blind eye to pretty obvious misrepresentations, and reducing the importance of the due diligence certificate to a mere formality, which was totally devoid of any kind of moral responsibility. SEBI guidelines were flouted on a regular basis by taking advantage of any loophole which could be found. They treated the SEBI Acknowledgement Card as a clean-chit given by SEBI which absolves them form all responsibilities. Matters came to such a state that there was no single person responsible for any sort of discrepancies, wrongful disclosures, inadequate or misleading information etc., intentionally or otherwise, in the offer documents. Merchant Bankers, SEBI and the issuing company seemed to be engrossed in a game of passing the parcel with each one shifting the blame and responsibility on the others. Pushed against the wall, the investors reacted by going on a prolonged holiday which forced the market and all its intermediaries to take a second look.

The merchant banking community realized the importance of specialization and also the need to bring international standards of services to the profession. Foreign collaborations were sought like ICICI tied up with JP Morgan to promote a joint venture ICICI Securities and Finance Co. Ltd.

The increase in the number of registered merchant bankers created unhealthy competition in the market. Besides, there was a significant increase in the number of new promoters coming out with new projects. Merchant bankers are solely responsible for appraising the projects of their economic and financial viability. But appraising a project calls for experience and professional knowledge of the highest order market and specially investors experienced the ill effects of free pricing concept after abolition of CCI and by handling of issues by immature and unethical merchant bankers. In 1994 when SEBI made proportionate allotment compulsory and raised minimum subscription from Rs.1000 to Rs.5000, the market was put on institutionalization of the market. Accordingly merchant bankers had to mend their strategy. They evolved their marketing

strategies which were oriented towards large investors, or the wholesale investors. Further, since they were to deal with institutional investors who are informed buyers, the merchant bankers became more conscious while selecting the issuer. To some extent weak merchant bankers were out of the business. This compelled many merchant bankers to move to other related and permitted activities. Many merchant bankers used their network to moblise only fixed deposits.

In an attempt to prune down the number of Category I Merchant Bankers, SEBI increased the minimum net worth required of them from Rs.1 crore to Rs.5 crore. The reintroduction of imposing penalty points on erring merchant bankers was welcome step. SEBI passed on to the lead managers the power of vetting offer documents for issues.

SEBI's decision in early 1995 to make underwriting optional for new issues lead to slump in the business of merchant bankers who are engaged in underwriting. Underwritten amount reduced from 88 per cent (of the issue amount of Rs.6060.8 crore) being Rs.5360 crore in 1992-93 to mere 28 per cent (of the issue amount of Rs.10981.7 crore) being Rs.3060 crore in 1995-96. The number of issue underwritten also came down from 98 per cent of (of the issues made i.e. 528) being 518 to 31 per cent (of the issue made i.e. 1428) being 440.

In post CCI period free pricing was a boon for promoters since merchant bankers used to give them a green signal to go ahead with high premium. It was observed that those merchant bankers, who aggressively priced issues so that the company can charge a higher premium, were preferred. But in all this the lead manager's responsibility towards the investor was all but forgotten. It was supposed to appraise the project and price it according to its true worth. But this was seldom done. On the other hand the promoters with the backing of a few brokers massively rigged the price of their share on the secondary market prior to the public issue and then the lead managers very smugly referred to the prevailing market price in the offer document to justify the high price. It was seen that promoters were using the proceeds of the loan to buy their own stock from the market to jack up their price. Promoter of the infamous MS Shoes was charged of

using this route to prop up his stock on the BSE. The capacity of merchant banker to evaluate projects were doubted. Certainly MS Shoes episode made merchant banker conscious of their reputation. They attempted coming odds with the promoters. To cite an example, in April 1995 Apple Industries Ltd., which was to lead manager to an issue by Continental Engineers, withdrew citing lapses on the promoters part to disclose information. Apple Industries claimed that the promoters had not informed them that a joint venture with Shannon Development Authority, Ireland had expired. Apple withdrew its “due diligence” certificate granted to Continental and surrendered the acknowledgement card received from SEBI. Apple claimed that as responsible lead managers and to protect the interests of investors it was withdrawing from the issue. This episode was a pointer to the fact that merchant bankers are slowly cleaning up their act and avoiding issues with questionable credentials.

Lead managers made more responsible

The primary motive for the investor, be it an individual or a corporate entity, in subscribing to public offerings is to get adequate returns on their investment in the form of dividend/interest income and capital appreciation. The lead manager has to carry the multiple responsibility of serving his client and also ensuring the overall quality of the issue to protect the interests of the investors and smooth working and growth of the capital market. The critical parameters in this connection are the promoter group, the project(s) undertaken and the offer price of the securities. The viability and profitability of the project(s) undertaken and the strength of the promoter group in terms of their track record, project management capabilities and synergy of their present interest with proposed activities are undoubtedly key parameters in determining the strength of an issue.

The recent past has witnessed inherently strong offerings from even established houses receiving a poor response from the investing community due to aggressive pricing. There have been a few cases where the offer price has even been higher than the market price of the shares at the time of the issue. Apart from the often touted reason of a

transition phase for the fee pricing regime, the situations has been aggravated by some of the lead managers trying to get assignments by promising a higher premium.

The post-issue scenario was an area where investors have suffered over the year, as some companies have been known to be lax in dispatching certificates and refund orders and in ensuring listing on all the Stock Exchanges as mentioned in the offer document. Lead managers had to ensure proper compliance with the existing guidelines and time schedules and also redress investor complaints within a reasonable period of time after the completion of the issue formalities.

The importance of due diligence in ensuring proper disclosure in order to enable investors to take informed investment decisions can hardly be understated. While the regulatory bodies are responsible for setting the disclosure norms, the lead managers had to ensure adequate disclosure of all important information relevant to an issue instead of interpreting the nuances of existing guidelines.

Business Potentials

For merchant banking business the year 1995-96 proved to be fatal since half of about 1000 merchant bankers did not have any issue to handle. As per a survey by 'Prime Database' only 472 merchant bankers out of 1000 strong merchant banking community handled any issue at all either in lead manager, co-manager, or advisory capacity in the said period. Out of 472 only 261 were engaged as lead managers, 52 merchant bankers handled only one issue and 33 handled two issues each in the whole year.

During 1995-96 since the assignments with merchant bankers were few, a move started where in merchant bankers category IV objected to advisory role in merchant banker category I. Advisory role in open to all categories, whereas only a category I merchant banker can lead manage an issue. According to category IV merchant bankers, there is a conflict of interests when category I merchant bankers are also allowed to be advisors to an issue. Category IV merchant bankers are, in fact asked for segregation between the functions of investment banking and advisor role for the corporate finance

team. The principal complaint was that a category I banker can use his financial muscle to get the advisory role whereas others in category III and IV were perfectly capable of performing. Interestingly, much of the business is generated by category III and IV merchant bankers. Naturally, after they have done a considerable amount of initial advisory work in terms of the project, its financial structuring and in many cases even recommending the issue price, it hurts to see that the title of advisor goes to a category I banker.

Association

SEBI contemplated the merchant bankers as Self Regulatory Organization (SRO). In this process merchant bankers promoted Association of Merchant Bankers of India (AMBI). At different times it has acted as spokesman of merchant bankers. It prepared a due diligence report defining the role and responsibilities of merchant bankers and also suggested measures for evolving standard norms for exercising ‘due diligence’ in capital issue. It prescribed a ‘due diligence’ checklist which enlists the areas to be covered during such exercise. The seven areas identified are :

i) General background about the company

ii) Management and Control,

iii) Industry and Competitors

iv) Human resources,

v) Operations

vi) Financial considerations and

vii) Legal

A SEBI-AMBI interface committee was proposed with proposals to pass on some important powers to AMBI from SEBI. In this emerging SRO, difference of opinion was highlighted amongst private sector and public sector merchant banks. Consequently another association known as Federation of Merchant Bankers and Finance Companies (FMBFC) emerged. Besides providing a feed back channel for regulatory bodies, it

proposes inter allia to safeguard the professionals interests of its members and educate investors on an ongoing basis.

Inspection

On the other hand to keep the merchant bankers disciplined SEBI started inspecting the merchant bankers of all the four categories. It is to scrutinize the quality of services provided by merchant bankers as well as to ensure that they follow the regulations and guidelines issued from time to time. SEBI claims that such inspection will be initiated generally as a follow up measure to investor complaints. Through inspection SEBI wants merchant bankers to be greater accountable and responsible. SBI Capital Market (SBI Caps) was debarred from operating for six months in December 1995 when many irregularities were detected during inspection by SEBI.

SEBI officials have been pulling up merchant bankers for not honouring their commitments and generally not maintaining discipline in pursuit of commercial interests. The Executive Director of SEBI (primary market) at annual meeting of AMBI in December 1996 had gone to an extent to observe that “those merchant bankers who did not honour their commitments do not deserve to be in business”. Merchant bankers have been blamed for bringing poor quality issue in primary market and driving away the retail investors from the market. Finance Minister P. Chidambaram also made a statement that “the markets were ruined by poor quality issues brought by poor quality merchant bankers”. He planned the black sheep in the merchant banking community for current state of gloom in the capital market. These facts can be substantiated by quoting finding of a study of price performance of 40 equity issues, that hit the market between April 1995 and September 1996. Of the companies covered by study (41 in all) only three scrips were quoting above the offer price on the bourses in November end 1996. Two are quoted at offer price while the rest 36 scrips are quoted below the offer price.

SEBI to discipline the merchant banker took a firm stand by debarring 64 merchant bankers including leading members from public as well as private sector for not

complying with the direction of SEBI to furnish information about their employees to SEBI in June 1997. Since SEBI proposed to disclose the investors about the track record of lead managers to a public/right issue, in March 1997 it sought information like names, educational qualifications, income tax details, bank account, details of any other business done in the name of self, spouse, child or parent passport number, ration card number and history of employment of the professionals working in merchant banking firms. Further, SEBI proposed to conduct test for capital market players in 1997. At least 20 per cent of personnel in such firms will be required to pass this test. The given certificate will be valid for 3 years. Such certification system is based on experience of developed and developing markets like U.S., U.K., Zambia, Sri Lanka.

Challenges

One general point which need attention is that ‘merchant banking is not only about issue management and underwriting as has been defined by SEBI in India. On this small and medium size operators entered into pure issue management and underwriting. Easy norms made for easy entry into merchant banking. Even after raising minimum net worth criterion new entrants entered but in absence of primary market activity they are sitting idle. In 1996-97 out of 1162 merchant bankers 720 did not have any assignment to handle. It will take time a appreciate the concept of merchant banking as “servicing every financial need of the client”. This concept will compel those who jumped into the business without a clear plan to exit. As market matures only a few large companies should survive.

Collaboration

Foreign collaboration appears to be imperative specially for merchant bankers who want to turn to external commercial borrowings and innovative fields like mergers and acquisitions. The foreign collaboration supported by sound financial position will enable merchant bankers to establish themselves in long run. Such collaborations enable sharing skill and knowledge of experienced partners. SEBI proposes to conduct test for merchant

banks also besides other intermediaries. This is so because SEBI has made quality of manpower one criteria for renewal of merchant banking licence. Thus, merchant bankers are to pure skill upgradation. This is also necessary since Indian market is no longer a sellers market and competition is forcing marketing skills to emerge. Merchant banking in India is still at a very primitive stage. As it matures only a few large companies will survive. Merchant bankers with innovative ideas will flourish.

7.7 SUMMARY

Merchant banking is a type of financial service that involves issues management and other related activities. Merchant bankers are the institutions engaged in the providing merchant banking services to corporate entities. There are several kinds of service rendered by merchant bankers. These include project counselling, credit syndication, corporate counselling, portfolio management, stock broking, venture capital, bill discounting, leasing, factoring, underwriting etc. SEBI has issued SEBI (Merchant Banking) Regulation on merchant banking. The regulation are applicable only to limited activities undertaken by merchant banker. Besides this, operational guidelines are required to be followed by merchant bankers in the discharge of their duties. They have pre-issue and post-issue obligations, which are a part of issue management.

7.8 KEYWORDS

Merchant Bank: It is an organisation that underwrites corporate securities and advises clients on various issues involved in the ownership of commercial ventures.

Corporate Counselling: Services providing towards ensuring efficient running of a corporate enterprise are called corporate counselling.

Credit Syndication: It is concerned with extending finance in both Indian rupees and Foreign currency, on a consortium basis.

Underwriter: An investment and banking firm, which enters a contract with the issuer of

new securities to distribute them to the investing public.

7.9 SELF ASSESSMENT QUESTIONS

1. Discuss the services rendered by merchant bankers.
2. Explain the role of SEBI in regulating the merchant banking operations in India
3. Who is lead manager? Discuss his duties and liabilities.
4. Discuss the code of conduct laid down for merchant bankers by SEBI. What is its need?
5. Discuss in detail the authorized activities of merchant bankers as per SEBI.

7.10 SUGGESTED READINGS

Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.
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Class	**:**	**MBA**	**Updated by :**	**Dr. M.C. Garg**
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Subject	**:**	**Management of Financial Services**		

LESSON-8

LEASING AND HIRE PURCHASE

STRUCTURE

8.0 Objective

8.1 Introduction

8.2 Concept and Essentials of Leasing

8.3 Classification of Leasing

8.4 Steps involved in Leasing Transaction

8.5 Advantages of Leasing

8.6 Limitation of Leasing

8.7 Legal Aspects of Leasing

8.8 Contents of a Lease Agreement

8.9 Income Tax Provisions relating to Leasing

8.10 Sales Tax Provisions pertaining to Leasing

8.111 Accounting Treatment of Lease

8.12 Structure of Leasing Industry in India

8.13 Problem of Leasing

8.14 Prospects of Leasing

8.15 Hire Purchase

8.16 Summary

8.17 Keywords

8.18 Self Assessment Questions

8.19 Suggested Readings

8.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define leasing and explain its essentials.

(b) Discuss the advantages, limitations and classification of leasing.

(c) Explain the various legal aspects of leasing.

(d) Define hire purchase and its features.

8.1 INTRODUCTION

Traditionally firms acquire productive assets and use them as owners. The sources of finance to a firm for procuring assets may be internal or external. Over the years there has been a declining trend in the internally generated resources due to low profitability. The financial institutions experience paucity of funds at their disposal to meet the increasing needs of borrowers. Further, modern business environment is becoming more and more complex. To succeed in the situation, the firms aim at growth with stability. To accomplish this objective, firms are required to go for massive expansion, diversification and modernisation. Essentially such projects involve a huge amount of investment. High rate of inflation, severe cost escalation, heavy taxation and meagre internal resources forced many companies to look for alternative means of financing the projects. Leasing has emerged as a new source of financing capital assets.

8.2 CONCEPT AND ESSENTIALS OF LEASING

Leasing, as a financing concept, is an arrangement between two parties, the leasing company or lessor and the user or lessee, whereby the former arranges to buy capital equipment for the use of the latter for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time,

according to the mutual convenience of both the parties. However, the lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Conceptually, a lease may be defined as a contractual arrangement /transaction in which a party owning an asset/equipment (lessor) provides the asset for use to another/transfers the right to use the equipment to the user (lessee). Over a certain/for an agreed period of time for consideration in the form of/in return for periodic payment (rentals) with or without a further payment (premium). At the end of the period of contract (lease period), the asset/ equipment reverts back to the lessor unless there is a provision for the renewal of the contract. Leasing essentially involves the divorce of ownership from the economic use of an asset/equipment. It is a device of financing the cost of an asset. It is a contract in which a specific equipment required by the lessee is purchased by the lessor (Financier) from a manufacturer/vendor selected by the lessee. The lessee has possession and use of the asset on payment of the specified rentals over a predetermined period of time. Lease financing is thus a device of financing/money lending. The real function or a lessor is not renting of asset but lending of funds/finance/credit and lease financing is in effect a contract of lending money. The lessor (financier) is the nominal owner of the asset as the possession and economic use to the equipment vests in the lessee. The lessee is free to choose the asset according to his requirements and the lessor dose not take recourse to the equipment as long as the rentals are regularly paid to him.

The essential elements of leasing are the following :

1. **Parties to the Contract :** There are essentially two parties to a contract of lease financing, viz, the owner and the user, respectively called the lessor and the lessee Lessors as well as lessees may be individuals, partnerships, joint stock companies,

corporations or financial Institution. Sometimes. there may be joint lessors or joint lessess, particularly where the properties or the amount of finance involved is enormous. Besides, there may be a lease-broker who acts as an intermediary in arranging lease deals. Merchant banking divisions of certain foreign banks in India, subsidiaries of some Indian banks and even some private merchant bankers are acting as lease brokers. They charge certain percentage of fees for their services, ranging between 0.50 to I per cent. Besides, a lease contract may involve a 'lease financier', who refinances the lessor, either by providing term loans or by subscribing to equity or under a specific refinance scheme.

2. **Asset :** The asset, property or equipment to be leased is the subject matter of a contract of lease financing. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, aircraft, etc. The asset must, however, be of the lessee's choice suitable for his business needs.

3. **Ownership Separated from user :** The essence of a lease financing contract is that during the lease tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

4. **Term of Lease :** The term of lease is the period for which the agreement of lease remains in operation. Every lease should have a definite period, otherwise it will be legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset (i.e., financial lease) or a period shorter than the useful life of the asset (i.e, operating lease). The lease may be perpetual, i.e., with an option at the end of the lease period to renew the lease for a further specific period.

5. **Lease Rentals :** The consideration which the lessee pays to the lessor for the lease transaction is the lease rental. The lease rentals are so structured as to compensate the lessor for the investment made in the asset (in the form of depreciation), the interest on the investment, repairs, etc. if any borne by the

1essor and servicing charges over the lease period.

6. **Modes of Terminating Lease :** At the end ot the lease period, the lease is terminated and various courses are possible, viz.,

(a) The lease is renewed on a perpetual basis or for a definite period,

(b) The asset reverts to the lessor,

(c) The asset reverts to the lessor and the lessor sells it to a third party,

(d) The lessor sells the asset to the lessee.

The parties may mutually agree to and choose any of the aforesaid alternatives at the beginning of the lease nature.

8.3 CLASSIFICATION OF LEASING

An equipment lease transaction can differ on the basis of (1) the extent to which the risks and rewards of ownership are transferred, (ii) number of parties to the transaction, (iii) domiciles of the equipment manufacturer, the lessor and the lessee, etc. Risk with reference to leasing refers to the possibility of loss arising on account of under-utilization or technological obsolescence of the equipment while reward means the incremental net cash flows that are generated from the usage of the equipment over its economic life and the realization of the anticipated residual value on expiry of the economic life. On the basis of these variations, leasing can be classified into the following types:

(a) Finance lease and operating lease

(b) Sales and lease back, and direct lease

(c) Single investor lease and leveraged lease

(d) Domestic lease and International lease

(a) Finance Lease and Operating Lease

Finance Lease : According to the International Accounting Standards (IAS-17), in a finance lease the lessor transfers to the lessee, substantially all the risks and rewards

incidental to the ownership of the asset whether or not the title is eventually transferred. It involves payment of rentals over an obligatory non-cancelable lease period, sufficient in total to amortize the capital outlay of the lessor and leave some profit. In such leases, the lessor is only a financier and is usually not interested in the assets. It is for this reason that such leases are also usually not interested in the assests, It is for this reason that such leases are also called full payout leases as they enable a lessor to recover his investment in the lease and device a profit types of assets. Included under such lease are ships, aircraft, railway wagons, lands, building heavy machinery, diesel generating sets and so on.

The IAS-17 stipulates that a substantial part of the ownership related risks and rewards in leasing are transferred when :

(i) The ownership of the equipment is transferred to the lease by the end of the lease term or

(ii) The lease has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable and at the stipulation of the lease it is reasonable certain that the option will be exercise

(iii) The lease term is for a major part of the useful life of the asset. The title may not eventually be transferred. The useful life of an asset refers to the minimum of its :

1) Physical life in terms of the period for which it can perform its function,

2) Technological life in the sense of the period in which it does not become obsolete.

3) Product market life deemed as the period during which its product enjoys satisfactory market.

The criterion/cut-off point is that if the lease term exceeds 75 per cent of the useful life of the equipment, it is a finance lease.

(iv) The present value of the minimum lease payment is greater than, or substantially

equal to, the fair market value of the asset at the inception of the lease (cost or equipment). The title may or may not be eventually transferred. The cut-off point is that the present value exceeds 90 per cent of the fair market value of the equipment. The present value should be computed using a discount rate equal to the rate implicit in the lease in the case of lessor and, in the case of the lessee, upon the incremental borrowing rate

In India, however, a lease is a finance lease, if one of the last two conditions, is satisfied. A lease agreement with any of the first two conditions is treated as hire-purchase agreement.

A finance lease is structured to include the following features :

(i) The lessee (the intending buyer) selects the equipment according to his requirement from its manufacturer or distributor.

(ii) The lessee negotiates and settles with the manufacturer or distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment, etc.

(iii) The lessor purchases the equipment either directly from the manufacturer or distributor (under straight-forward leasing) or from the lessee after the equipment is delivered (under sale and lease back).

(iv) The lessor then leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment.

(v) A finance lease may provide a right or option, to the lessee, to purchase the equipment at a future date. However, this practice is rarely found in India

(vi) The lease period spreads over the expected economic life of the asset. The lease is originally for a non-cancelable period called the primary lease period during which the lessor seeks to recover his investment along with some profit. During this period cancellation of lease is possible only at a very heavy cost. Thereafter, the lease is subject to renewal for the secondary lease period, during which the rentals are substantially low.

(vii) The lessee is entitled to exclusive and peaceful use of the equipment during the entire lease period provided he pays the rentals and complies with the terms of the lease.

(viii) As the equipment is chosen by the lessee, the responsibility of its suitability, the risk of obsolescence and the liability for repair, maintenance and insurance or the equipment rest with the lessee.

Operating Lease: According to the IAS-17, an operating lease is one which is not a finance lease. In an operating lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period. The lessor provides services (other than the financing of the purchase price) attached to the leased asset, such as maintenance, repair and technical advice. For this reason, operating lease include a cost for the services provided, and the lessor does not depend on a single lessee for recovery of his cost. Operating lease is generally used for computers, office equipments, automobiles, trucks, telephones, etc.

An operating lease is structured with the following features :

(i) An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases it may be even on hourly, daily, weekly or monthly basis. The lease is cancelable by either party during the lease period.

(ii) Since the lease periods are shorter than the expected life of the asset, the lease rentals are not sufficient to totally amortize the cost of the assets.

(iii) The lessor does not rely on the single lessee for recovery of his investment. He has the ultimate interest in the residual value of the asset. The lessor bears the risk of obsolescence, since the lessee is free to cancel the lease at any time.

(iv) Operating lease normally include maintenance clause requiring the lessor to maintain the leased asset and provide services such as insurance, support stair, fuel, etc.

Examples of Operating leases are:-

(a) Providing mobile cranes with operators,

(b) Chartering of aircraft and ships, including the provision of crew, fuel and support services.

(c) Hiring of computers with operators,

(d) Hiring of taxi for a particular travel, which includes service of driver, provision for maintenance, fuel immediate repairs, etc.

(b) Sale and Lease Back and Direct Lease

Sale and Lease back : In a way, it is an indirect from of leasing. The owner of an equipment/asset sells it to a leasing company (Lessor) which leases it back to the owner (lessee). A classic example of this type of leasing is the sale and lease back of safe deposits values by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The leasing company in turn offers these lockers on a long-term basis to the bank. The bank subleases the lockers to its customers. The lease back arrangement in sale and lease back type of leasing can be in the form of finance lease or operating lease.

Direct Lease : In direct lease, the lessee, and the owner of the equipment are two different entities a direct lease can be of two types : Bipartite and Tripartite Lease.

Bipartite Lease : There are two parties in the lease transaction, namely,

(i) equipment supplier-cum-lessor

(ii) lessee. Such a type of lease is typically structured as an operating lease with inbuilt facilities, like up gradation of the equipment (Upgrade Lease), addition to the original equipment configuration and so on. The lessor

maintains the asset and, if necessary, replaces it with a similar equipment in working conditions (Swap Lease).

Tripartite Lease : Such type of lease involves three different parties in the lease agreement : equipment supplier, lessor and lessee. An innovative variant of tripartite lease is the sales-aid lease under which the equipment supplier arranges for lease finance in various company;

- Providing reference about the customer to the leasing company,
- Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company,
- Writing the lease on his own account and discounting the lease receivables with the designated leasing company. The effect is that the leasing company owns the equipment and obtains an assignment of lease rental.

The sales-aid lease is usually with recourse to the supplier in the event of default by the lessee either in the form of offer from the supplier to buy back the equipment from the lessor or a guarantee on behalf of the lessee.

(c) Single Investor Lease and Leveraged Lease

Single Investor Lease : There are only two parties to the lease transaction – the lessor and the lessee. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds. The debts raised by the leasing company to finance the asset are without recourse to the lessee, i.e. in the case of default in servicing the debt by the leasing company, the lender is not entitled to payment from the lessee.

Leveraged Lease : There are three parties to the transaction : (i) lessor (equity investor), (ii) lender and (iii) lessee. In such type of lease, the leasing company (equity investor) buys the asset through substantial borrowing. The lender (loan participant) obtains an assignment of the lease and a first mortgaged asset on the leased asset. The transaction is routed through a trustee who looks after the interest of the lender and lessor. On receipt of the rentals from the lessee, the trustee remits the debt service component of the rental

to the loan participant and the balance to the lessor.

Like other lease transactions, leveraged lease entitles the lessor to claim tax shields on depreciation and other capital allowances on the entire investment cost including the non-recourse debt. The return on equity (profit after tax divided by net worth) is, therefore, high. From the lessee's point of view, the effective rate of interest implicit in the lease arrangement is less than on a straight loan as the lessor passes on the portion of the tax benefits to the lessee in the form of lower rental payments. Leveraged lease packages are generally structured for leasing investment-intensive assets like aircrafts, ships, etc,

(d) Domestic Lease and International Lease

Domestic Lease: A lease transaction is classified as domestic if all parties to the agreement, namely, equipment supplier, lessor and the lessee, are domiciled in the same country.

International Lease : If the parties to the lease transaction arc domiciled in different countries, it is known as international lease, This type of lease is further sub-classified into (I) Import Lease and (2) cross-border lease.

Import Lease : In an import lease, the lessor and the lessee are domiciled in the same country, but the equipment supplier is located in a different country The lessor imports the asset and leases it to the lessee.

Cross-border Lease : When the lessor and the lessee are domiciled in different countries, the lease is classified as cross-border lease, The domicile of the supplier is immaterial.

Operationally, domestic and international leases are differentiated on the basis of risk. The latter type of lease transaction is effected by two additional risk factors, i,e, country risk and currency risk. The country risk arises from the need to structure the lease transaction in the light of an understanding of the political and economic climate and a knowledge or the tax and regulatory environment governing them in the foreign

countries concerned. As the payment to the supplier and the lease rentals are denominated in different currencies, any variation in the exchange rate will involve currency risk.

8.4 STEPS INVOLVED IN LEASING TRANSACTION

The steps involved in a leasing transaction are summarised as follows:

1. First, the lessee has to decide the asset required and select the suppler. He has to decide about the design specifications, the price, warranties, terms of delivery, servicing etc.

2. The lessee, then enters into a lease agreement with the lessor. The lease agreement contains the terms and conditions of the lease such as,

   (a) The basic lease period during which the lease is irrecoverable.

   (b) The timing and amount of periodical rental payments during the lease period.

   (c) Details of any option to renew the lease or to purchase the asset at the end of the period.

   (d) Details regarding payment of cost of maintenance and repairs, taxes, insurance and other expenses.

3. After the lease agreement is signed the lessor contacts the manufacturer and requests him to supply the asset to the lessee. The lessor makes payment to the manufacturer after the asset has been delivered and accepted by the lessee.

8.5 ADVANTAGE OF LEASING

To the Lessee : Lease financing has the following advantages to the lessee:

- **Financing of Capital goods :-** Lease financing enables the lessee to have finance for huge investments in land, building, plant, machinery, heavy equipments, etc., up to 100 per cent, without requiring any immediate down payment. Thus, the lessee is able to commence his business virtually without making any initial investment (of course, he may have to invest the minimal sum of working capital

needs).

- **Additional Source of Finance :-** Leasing facilitates the acquisition of equipment, plant and machinery, without the necessary capital outlay, and, thus, has a competitive advantage of mobilizing the scarce financial resources of the business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

- **Less Costly :-** Leasing as a method of financing is less costly than other alternatives available.

- **Off-Balance Sheet Financing :-** Neither the leased asset is depicted on the balance sheet, nor the lease liability is shown, except that the fact of lease arrangement is mentioned by way of a footnote. Lease financing, therefore, does not affect the debt raising capacity of the enterprise, the lessor's security being also confirmed to the leased asset

However, the advantage is by, and large, more apparent than real. Development banks and other lending agencies do not base their decision to lend solely on the apparent strength of the balance sheet of the borrower. They certainly call for information regarding the off-balance sheet liabilities to assess the real borrowing capacity.

But the off-balance sheet financing can be misleading to lenders who rely on the financial statements. In brief, the non-disclosure of outstanding lease obligations and the value of the leased assets in the balance sheet would result in (i) understatement of debt - equity ratio and (ii) Over statement of asset turnover ratio as well as return on investment. They under-estimate the real risk and over-estimate the value of the firm as they are affected by these variables. In recognition of the distortions implicit in the non-disclosures of finance lease in the financial statements of the lessee, the IAS-17 has recommended capitalization of finance leases in the books of the lessee.

- **Ownership Preserved: -** Leasing provides finance without diluting the ownership or control of the promoters. Against it, other modes of long-term finance, viz,

equity or debentures, normally dilute the ownership of the promoters.

- **Avoid Conditionalities:-** Lease finance is considered preferable to institutional finance, as in the former case, there are no conditionalities. Lease financing is beneficial since it is free from restrictive covenants and conditionalities, such as, representations on the board, conversion of debt into equity, payment of dividend, etc, which usually accompany institutional finance and term loans from banks.
- **Flexibility in Structuring of Rentals:-** The lease rentals can be structured to accommodate the cash flow situation of the lessee, making the payment of rentals convenient to him. The lease rentals are so tailor-made that the lessee is able to pay the rentals from the funds generated from operations. The lease period is also chosen so as to suit the lessee's capacity to pay rentals and considering the operating life-span of the asset.
- **Simplicity:-** A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation. As against it, institutional finance and term loans require compliance of covenants and formalities and bulk of documentation, causing procedural delays.
- **Tax Benefits:-** By suitable structuring of lease rentals, a lot of tax advantages can be derived. If the lessee is in a tax paying position, the rental may be increased to lower his taxable income. The cost of asset is thus amortized more rapidly than in a case where the asset is owned by the lessee, since depreciation is allowable at the prescribed rates. If the lessor is in tax paying position, the rentals may be lowered to pass on a part of the tax benefit to the lessee. Thus, the rentals can be adjusted suitably for postponement of taxes.
- **Obsolescence Risk is Averted :-** In a lease arrangement the lessor being the owner bears the risk of obsolescence and the lessee is always free to replace the asset with the latest technology.

To the Lessor :- A lessor has the following advantages :

- **Full Security :-** The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset if the lessee defaults. As against it, realising an asset secured against a loan is more difficult and cumbersome.
- **Tax Benefit :-** The greatest advantage for the lessor is the tax relief by way of depreciation. If the lessor is in high tax bracket, he can lease out assets with high depreciation rates, and thus, reduce his tax liability substantially. Besides, the rentals can be suitably structured to pass on some tax benefit to the lessees.
- **High Profitability :-** The leasing business is highly profitable since the rate of return is more than what the lessor pays on his borrowings. Also, the rate of return is more than in case of lending finance directly.
- **Trading on Equity :-** Lessors usually carry out their operations with greater financial leverage, That is, they have a very low equity capital and use a substantial amount of borrowed funds and deposits. Thus, the ultimate return on equity is very high.
- **High Growth Potential :-** The leasing industry has a high growth potential. Leasing financing enables the lessees to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital. Leasing, thus, maintains the economic growth even during recessionary period.

8.6 LIMITATIONS OF LEASING

Lease financing suffers from certain limitations too :

Restrictions on Use of Equipment:- A lease arrangement may impose certain restrictions on use or the equipment, or require compulsory insurance, etc. Besides, the lessee is not free to make additions or alterations to the leased asset to suit his requirements.

Limitations of Financial Lease:- A financial lease may entail higher payout obligations,

if the equipment is found not useful and the lessee opts for premature termination of the lease agreement. Besides, the lessee is not entitled to the protection of express or implied warranties since he is not the owner of the asset.

Loss of Residual Value:- The lessee never becomes the owner of the leased asset. Thus, he is deprived of the residual value of the asset and is not even entitled to any improvements done by the lessor or caused by inflation or otherwise, such as appreciation in value of leasehold land.

Consequences of Default:- If the lessee defaults in complying with any terms and conditions of the lease contract, the lessor may terminate the lease and take over the possession of the leased asset. In case of finance lease, the lessee may be required to pay for damages and accelerated rental payments.

Understatement of Lessee's Asset :- Since the leased assets do not form part of lessee's assets, there is an effective understatement of his assets, which may sometimes lead to gross under-estimation of the lessee. However, there is now an accounting practice to disclose the leased assets by way or footnote to the balance sheet.

Double Sales Tax:- With the amendment of sale-tax law in various states, a lease financing transaction may be charged to sales tax twice-once when the lessor purchases the equipment and again when it is leased to the lessee.

8.7 LEGAL ASPECTS OF LEASING

There is no separate statute for equipment leasing in India. The provisions relating to bailment in the Indian Contract Act govern equipment leasing agreements as well Section 148 of the Indian Contract Act define bailment as : -

The delivery of goods by one person to another, for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed off according to the directions of the person delivering them. The person delivering the goods is called the' bailor' and the person to whom they are delivered is called the

'bailee'.

Since an equipment lease transaction is regarded as a contract of bailment, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (other than those expressly specified in the least contract) as defined by the provisions of sections 150 and 168 of the Indian Contract Act. Essentially these provisions have the following implications for the lessor and the lessee.

1. The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset, and to leave the asset in peaceful possession of the lessee during the currency of the agreement.
2. The lessee has the obligation to pay the lease rentals as specified in the lease agreement, to protect the lessor's title to take reasonable care of the asset, and to return the leased asset on the expiry of the lease period.

8.8 CONTENTS OF A LEASE AGREEMENT

The lease agreement specifies the legal rights and obligations of the lessor and the lessee. It typically contains terms relating to the following :

1. Description of the lessor, the lessee, and the equipment.
2. Amount, time, and place of rental payments.
3. Time and place of equipment delivery.
4. Lessee's responsibility for taking delivery and possession of the leased equipment.
5. Lessee's responsibility for maintenance, repairs, registration, etc and the lessor's right in case of default by the lessee.
6. Lessee's right to enjoy the benefits of the warranties provided by the equipment manufacturer/supplier.
7. Insurance to be taken by the lessee on behalf of the lessor.
8. Variation in lease rentals if there is a change in certain external factors like bank

interest rates, depreciation rates, and fiscal incentives.

9. Option of lease renewal for the lessee.

10. Return of equipment on expiry of the lease period.

11. Arbitration procedure in the event of dispute.

8.9 INCOME TAX PROVISIONS RELATING TO LEASING

The principal income tax provisions relating to leasing are as follows:

1. The lessee can claim lease rentals as tax-deductible expenses.
2. The lease rentals received by the lessor are taxable under the head of 'Profits and Gains of Business or Profession'.
3. The lessor can claim depreciation on the investment made in leased assets.

8.10 SALES TAX PROVISIONS PERTAINING TO LEASING

The major sales tax provisions relevant for leasing are as follows:

1. The lessor is not entitled for the confessional rate of central sales tax because the asset purchased for leasing is meant neither for resale nor for use in manufacture. (It may be noted that if a firm buys an asset for resale or for use in manufacture it is entitled for the confessional rate of sales tax).

2. The 46th Amendment Act has brought lease transitions under the purview of 'sale' and has empowered the central and state government to levy sales tax on lease transactions. While the Central Sales Tax Act has yet to be amended in this respect, several state governments have amended their sales tax laws to impose sales tax on lease transactions.

8.11 ACCOUNTING TREATMENT OF LEASE

Presently the accounting treatment of lease transactions in India is as follows:

1. The leased asset is shown on the balance sheet of the lessor.
2. Depreciation and other tax shields associated with the leased asset are claimed by the lessor.
3. The entire lease rental is treated as income in the books of the lessor and as expense in the books of the lessee.

In nutshell, from the point of view of the lessee, a lease transaction represents an off-the balance-sheet transaction and this appears to be an important advantage associated with leasing. It may be noted that in countries like the United States and the United Kingdom, where leasing is very popular, leases which meet certain criteria are capitalised in the books of the lessee. This essentially implies that:

(a) the leased asset and the corresponding liability (reckoned at the present value of the stream of rental payments) are shown on the balance sheet of the lessee.

(b) depreciation charges are claimed by the lessee, and

(c) the lease rental is split into two parts, the interest component (which is charged to the profit and loss statement) and the principal repayment component.

8.12 STRUCTURE OF LEASING INDUSTRY IN INDIA

The present structure of leasing industry in India consists of (i) Private Sector Leasing and (ii) Public Sector Leasing.

The private sector leasing consists of :

(i) Pure Leasing Companies.

(ii) Hire Purchase and Finance Companies and

(iii) Subsidiaries of Manufacturing Group Companies.

The public sector leasing organisation are divided into:

(i) Leasing divisions of financial institutions.

(ii) Subsidiaries of public sector banks.

(iii) Other public sector leasing organisations.

(i) Pure Leasing Companies

These companies operate independently without any link or association with any other organisation or group of organisation. The First Leasing Company of India Limited, The Twentieth Century Finance corporation Limited, and the Grover Leasing Limited, fall under this category.

(ii) Hire Purchase and Finance Companies

The companies started prior to 1980 to do hire purchase and finance business especially for vehicles added leasing to their activities during 1980. Some of them do leasing as major activity and some others do leasing on a small scale as a tax planning device. Sundaram Finance Limited and Motor and General Finance Limited belong to this group.

(iii) Subsidiaries of Manufacturing Group Companies

These companies consist of two categories vendor leasing and in house leasing

(a) Vendor Leasing : This type of companies are formed to boost and promote the sale of its parent companies products through offering leasing facilities.

(b) In house leasing : In house leasing or capture leasing companies are set up to meet the fund requirements or to avoid the income tax liabilities of the group companies.

PUBLIC SECTOR LEASING

(i) Financial Institutions : The financial institution such as IFCI, ICICI, IRBI and NSIC have set up their leasing divisions or subsidiaries to do leasing business. The Shipping Credit and Investment Company of India offers leasing facilities in foreign currencies for ships, deep seas fishing vehicles and related equipments to its clients.

(ii) Subsidiaries of Banks: The commercial banks in India can under section 19(1) of the Banking Regulation Act, 1949, set up subsidiaries for undertaking leasing activities. The SBI was the first bank to start a subsidiary for leasing business in 1986.

Leasing in SBI is transacted through, Strategic Business Unit (SBU) of the bank. Each SBU is manned by specially trained staff and is equipped with the latest technological aids to meet the needs of top corporate clients. For the bank as a whole, leasing is considered as a high growth area. Now the bank is concentrating only on 'Big Ticket Leasing' which is generally of Rs. 5 crore and above. So far SBI has disbursed more than Rs.300 crores by way of leasing with the average size of deal being Rs. 25 crores.

(iii) Other Public Sector Organisations: A few public sector manufacturing companies such as Bharat Electronics Limited, Hinudustan Packaging Company Limited, Electronic Corporation of India Limited have started to sell their equipment through leasing.

8.13 PROBLEM OF LEASING

Leasing has great potential in India. However, leasing in India faces serious handicaps which may mar its growth in future. The following are some of the problem :

1. Unhealthy Competition

The market for leasing has not grown with the same pace as the number of lessors. As a result, there is over supply of lessors leading to competition. With the leasing business becoming more competitive, the margin of profit for lessors has dropped from four to five per cent to the present 2.5 to 3 per cent. Bank subsidiaries and financial institutions have the competitive edge over the private sector concerns because of cheap source of finance.

2. Lack of Qualified Personnel

Leasing requires qualified and experienced people at the helm of its affairs. Leasing is a specialised business and persons constituting its top management should have expertise in accounting, finance, legal and decision areas. In India, the concept of leasing business is of recent one and hence it is difficult to get right man to deal with leasing business. On account of this, operations of leasing business are bound to suffer.

3. Tax Considerations

Most people believe that lessees prefer leasing because of the tax benefits it offers. In reality, it only transfers, the benefit i.e. the lessee's tax shelter is lessor's burden. The lease becomes economically viable only when the transfer's effective tax rate is low. In addition, taxes like sales tax, wealth tax, additional tax, surcharge etc. add to the cost of leasing. Thus leasing becomes more expensive from of financing than conventional mode of finance such as hire purchase.

4. Stamp Duty

The States treat a leasing transaction as a sale for the purpose of making them eligible to sales tax. On the contrary, for stamp duty, the transaction is treated as a pure lease transaction. Accordingly a heavy stamp duty is levid on lease documents. This adds to the burden of leasing industry.

5. Delayed Payment and Bad Debts

The problem of delayed payment of rents and bad debts add to the costs of lease. The lessor does not take into consideration this aspect while fixing the rentals at the time of lease agreement. These problems would disturb prospects of leasing business.

8.14 PROSPECTS OF LEASING

Leasing today accounts for six per cent of the total capital investment in India. Leasing will play a significant role to account for at least 15 per cent of gross capital

formation.

The world leasing industry grew at a rate of about 10 per cent. As the economy is opened up there will be substantial demand for a variety of leasing products such as foreign currency leases, cross border leases, leverage leases etc. Leasing companies set for substantial growth in line with international trends.

Leasing has great prospects in India. It is on the threshold of a major break through in industrial development due to liberalised economic policy measures initiated by the government. Leasing as a convenient and flexible financing option can play a vital role in the process of industrial development. The leasing industry has taken the centre stage with the government and public sector undertakings are looking to industry to finance railway, telecommunication, transport, power and infrastructure sectors. The infrastructure financing so crucial for an economic growth can not be accelerated without leasing industry. The government has indicated that it is open to suggestions for reviewing the existing policies. Such conduciveness and the willingness to prevent bottlenecks in the area of taxation and other areas will go a long way in speeding up the growth of the industry.

8.15 HIRE PURCHASE

Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company(creditor) to the hire purchase customer(hirer). The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with creditor and passes on to hirer on the payment of last installment.

Features of Hire Purchase Agreement

1. Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.
2. Each installment is treated as hire charges.

3. The ownership of the goods passes on the hirer on the payment of last installment.
4. In case the buyer makes any default in the payment of any installment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charge.
5. The hirer has the right to terminate the agreement any time before the property passes. He has the option to return the goods in which case he need not pay installments falling due thereafter. However, he can not recover the sums already paid as such sums legally represent hire charge on the goods in question.

Legal Position

The Hire Purchase Act, 1972 defines a hire purchase agreement as, 'an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of agreement under which :

1. Payment is to be made in installments over a specified period.
2. The possession is delivered to the purchaser at the time of entering into a contract.
3. The property in the goods passes to the purpose on payment of the last installment.
4. Each installment is treated as hire charge so that if default is made in payment of any one installment, the seller is entitled to take away the goods.
5. The hirer / purchaser is free to return the goods without being required to pay any further instalments falling due after the return

Hire Purchase Agreement

There is no prescribed form for a hire purchase agreement, but it has to be in writing and signed by both parties to the agreement.

A hire purchase agreement must contain the following particulars:

(i) The description of goods in a manner sufficient to identity them.

(ii) The hire purchase price of the goods.

(iii) The date of commencement of the agreement.

(iv) The number of instalments in which hire purchase price is to be paid, the amount, and due date.

Hire Purchase and Credit Sale

Higher purchase transaction is different from credit sale. In case of actual sale, the title in the property i.e, ownership and possession is transferred to the purchaser simultaneously, in hire purchase the ownership remains with the seller until last instalment is paid.

Hire Purchase and Instalment Sale

Hire purchase transaction is different from instalment system. In case of instalment system it is not only the possession but also the ownership of goods which is transferred to the buyer immediately at the time of agreement. Further, when the buyer stops payment of dues, the seller, has no right to repossess the goods. He has the only right to sue the buyer for the non payment by returning the goods but has the right of disposing of the goods in any manner as he likes. Any loss of goods should be borne only by the buyer as risk lies with the ownership.

Hire Purchase and Leasing

Hire Purchase is also different from leasing on following grounds :

1. Ownership

In a contract of lease, the ownership rests with the lessor throughout and the lessee (hirer) has no option purchase the goods.

2. **Method of Financing**

Leasing is a method of financing business assets whereas hire purchase is a method of financing both business assets and consumers articles.

3. **Depreciation**

In leasing depreciation and investment allowance can not be claimed by the leasee. In hire purchase, deprecation and investment allowance can be claimed by the hirer.

4. **Tax Benefits**

The entire lease rental is tax deductible expense. Only the interest component of the hire purchase installment is tax deductible.

5. **Slavage Value**

The lessee, not being the owner of the asset, does not enjoy the salvage value of the asset. The hirer, in purchase, being the owner of the asset, enjoys salvage value of the asset.

6. **Deposit**

Lessee is not required to make any deposit whereas 20% deposit is required in hire purchase.

7. **Rent-Purchase**

With lease, we rent and with hire purchase we buy the goods.

8. **Extent of Finance**

Lease Financing is invariably 100 per cent financing. It requires no immediate down payment or margin money by the lessee. In hire purchase, a margin equal to 20-25 per cent of the cost of the asset is to be paid by the hirer.

9. **Maintenance**

The cost of maintenance of the hired asset is to be borne by the hirer himself. In case of finance lease only, the maintenance of leased asset is the responsibility of

the lessee.

10. **Reporting**

The asset on hire purchase is shown in the balance sheet of the hirer. The leased assets are shown by way of foot note only.

Bank Credit for Hire Purchase Business

The subsidiary of commercial banks lend to the dealer or to finance intermediary who has already financed articles sold by the dealer to the hirer under a hire purchase contract. While considering proposals from dealers or hire purchase financing companies, the bank subsidiary has to take extra precautions, looking to the particular nature of transaction under hire purchase contract.

When offered this type of business, the bank subsidiary would make an assessment of the standing and financial position of the dealer or of the hire purchase company, and take into consideration the principles of good lending and carry out the procedure below :

1. Customer

When approached for hire purchase facility the subsidiary should take care to make the assessment of the standing and financial position of the business customer.

2. Purpose

The type of goods being used to finance in the hire purchase transaction is of great importance. In the event of default the bank may reconsider repossessing the goods and selling them to clear the advance. Thus, if the goods can be readily sold elsewhere (e.g. a relatively new car), then these agreements are better security than those for (say} cameras. which will have a lower resale value.

3. Amount

Bank subsidiaries taking up hire purchase business would do well to discourage small individual loans. In order to ensure proper servicing and monitoring, it is also essential to a have floor limit in the amount of individual hire purchase transactions. While it may be about Rs. 50,000 for automobile sector, it may be about Rs. 10,000 for consumer durables.

4. Period

The facility will normally be extended over to three years.

5. Repayment

Repayment are spread evenly, or agreed, over the loan period. The repayment should be adaptable to the hirer's needs. The repayment can usually be tailor made to suit the income generated from the use of asset so that it is self-financing. Sometimes, repayment holidays can be allowed and repayment is delayed until the asset is operational or producing profit. To ensure timely recovery in the case or car two-wheeler, and consumer durable financing, it could be preferable to have institutional tie-ups with employers/employees' cooperative societies for the which eligibility criteria can be laid down.

6. Security

Technically hire purchase advance is against hypothecation of equipment/vehicles and pledge of hundis / pronotes and lodgements of hire purchase agreements. The bank subsidiary will ask the borrower to complete the bank's form of security to charge the security under an equitable/hypothecation charge. If the borrower is a limited company which is not of sufficient strength to allow equitable / hypothecation facility and if suitable security is not available it is normal to obtain a debenture over the assets of the company under which a floating charge is obtained.

If necessary the bank subsidiary will ask the hirer to furnish a guarantor of means and the bank would in such a case insist that the guarantor should also accept the hundies. It is a practice with some banks to insist for insurance policy to indemnify the bank against the default of the hirer. The premiums will be charged to the hirer. .

In view of the cost and difficulty of the repossession of a fast depreciating asset, the customer's ability to repay is vital and no reliance is placed on security.

7. **Monitoring and Control**

The bank needs to exercise control over the on-going situation. A periodical certificate should be obtained from the finance company at the monthly intervals, stating the total amount of outstanding but excluding those hire purchase agreements which have become in arrears and are, therefore, suspect. One or two months in arrears may be acceptable but more than that suggest that the particular hirer is in permanent default. The bank will keep a running total of these amounts, returning agreements which have become lapsed to their customers.

8.16 SUMMARY

A financial arrangement that provides a firm with the advantage of using an asset without owning it is known as leasing. A lease is of various types. The participants in a lease include the lessor and the lessee. The lessor extends several benefits to the parties involved in a lease arrangement. Leasing is of immense use to both the lessor and the lessee. Leasing facilitates accelerated production and sale of goods, provides tax benefits to lessee, gives a fillip to the capital market, provides a cheaper source of capital funds, and helps avoid capital outlay. However, leasing is fraught with many drawbacks. Hire purchase is a contractual arrangement under which the owner lets his goods on hire to the hirer and offers an option to the hirer for purchasing the goods in accordance with the terms of the contract.

8.17 KEYWORDS

Lease: Lease is a rental agreement whereby one person acquires the use of an asset on payment of periodical rentals.

Lessor: He is a person who conveys to another party the right to use an asset in consideration of a periodical rental payment.

Lessee: Lessee is a person who obtains the right to use the asset from the lessor for a periodical rental payment for an agreed period of time.

Financial Lease: A lease is defined as a financial lease if it transfers a substantial part of the risks and rewards associated with ownership from the lessor to the lessee.

Operating Lease: An lease other than a finance lease is known an operating lease.

Hire Purchase: Hire purchase refers to a transaction of finance whereby goods are bought and sold under certain terms and conditions, such as payment of periodic instalments, immediate possession of goods to the buyer etc.

8.18 SELF ASSESSMENT QUESTIONS

1. Define leasing. Explain the different kinds of leasing.
2. Discuss the advantages and disadvantages of leasing.
3. Discuss the superiority of lease finance over other alternatives.
4. Discuss the status of income tax and sales tax in context of leasing in India.
5. Define hire purchase. Discuss its features.

8.19 SUGGESTED READINGS

Varshney, P.N., and Mittal D.K., Indian Financial System, Sultan Chand & Sons, New Delhi.
Vinod Kothari, Lease Financing and Hire Purchase (Including Merchant Banking and Mutual Funds), Wadhwa and Co.(P). Ltd. Nagpur.
Sundharam, K.P.M., and Varshney, P.N., Banking and Financial System, Sultan Chand and Sons, New Delhi.
Meir, Kohn, Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

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LESSON-9

DEBT SECURITISATION

STRUCTURE

9.0 Objective

9.1 Introduction

9.2 Concept of Securitisation

9.3 Securitisation Vs. Factoring

9.4 Modus Operandi of Securitisation

9.5 Structure for Securitisation/Types of Securities

9.6 Securitisable Assets

9.7 Benefits of Securitisation

9.8 Securitisation and Banks

9.9 Conditions for Successful Securitisation

9.10 Securitisation Abroad

9.11 Securitisation in India

9.12 Causes for the Unpopularity of Securitisation in India

9.13 Summary

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9.15 Self Assessment Questions

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9.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define securitisation and differenciate it with factoring.

(b) Discuss the modus operandi of securitisation.

(c) Explain the benefits of securitisation and list out the causes for the unpopularity of securitisation in India.

(d) Trace out the development of securitisation in abroad and in India.

9.1 INTRODUCTION

The financial system all over the world is in the process of rapid transformation. As a result, the capital market, money market and the debt market are getting widened and deepened. It is interesting to note that new instruments and new products are emerging in the debt market too. In fact the development of a debt market increases the efficiency of a capital market to a greater extent. Again, along with the equity market, there is bound to be a natural growth in the debt market also. Thus, it is obvious that a debt market should also have both primary and secondary markets. In this context, debt or asset securitisation assumes a significant role and it is one of the most innovative techniques introduced in the debt market to achieve the above objective. Moreover, it is the debt market which has provided more impetus for capital formation than the equity market in the economically advanced countries.

9.2 CONCEPT OF SECURITISATION

Securitisation of debt or asset refers to the process of liquidating the illiquid and long term assets like loans and receivables of financial institutions by issuing marketable securities against them. In other words, it is a technique by which a long term, non-negotiable and high valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares.

Thus, it is nothing but a process of removing long term assets from the balance sheet of a lending financial institution and replacing them with liquid cash through the issue of securities against them. Under securitisation, a financial institution pools its illiquid, non-negotiable and long term assets, creates securities against them, gets them rated and sells them to investors. It is an ongoing process in the sense that assets are converted into securities, securities into cash, cash into assets and assets into securities and so on.

Generally, extension of credit by banks and other financial institutions in the form of bills purchase or discounting or hire purchase financing appears as an asset on their balance sheets. Some of these assets are long term in nature and it implies that funds are

locked up unnecessarily for an undue long period. So, it carry on their lending operations without much interruptions, they have to rely upon various other sources of finance which are not only costly but also not available easily. Again, they have to bear the risk of the credit outstandings. Now, securitisation is a readymade solution for them. Securitisation helps them to recycle funds at a reasonable cost and with less credit risk. In other words, securitisation helps to remove these assets from the balance sheets of financial institutions by providing liquidity through tradable financial instruments.

Again from another angle also, securitisation is a boon to financial institutions. From the risk management point of view, the lending financial institutions have to absorb the entire credit risk by holding the credit outstandings in their own portfolio. Securitisation offers a good scope for risk diversification. It is worthwhile to note that the entire transaction relating to securitisation is carried out on the asset side of the Balance Sheet. That is one asset (illiquid) is converted into another asset (cash).

As stated earlier, securitisation helps to liquidity assets mainly of medium and long term loans and receivables of financial institutions. The concept of securitisation can be defined as follows:

“A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset backed securities”.

Yet another simple definition is as follows:

“Securitization is nothing but liquifying assets comprising loans and receivables of an institution through systematic issuance of financial instruments”.

According to Hendersen, J. and Scott, J.P. “Securitisation is the process which takes when a lending institution’s assets are removed in one way or another from the balance sheet of that lending institution and are funded instead, by the investors who purchase a negotiable financial instrument evidencing this indebtedness without recourse, or in some cases with limited recourse, to the original lender”. Thus, financial assets can be made liquid through securitisation i.e., through packaging loans and selling them in

the market. It is very clear from the above definitions that securitisation is nothing but the packaging of a pool of financial assets into marketable securities. In brief, illiquid assets are converted into tradable securities.

Structured Securities Vs. Conventional Securities

Securitisation is basically a structured financial transaction. It envisages the issue of securities against illiquid assets and such securities are really structured securities. It is so because, they are backed by the value of the underlying financial asset and the credit support of a third party also. At this stage, one should not confuse such structured securities with conventional securities like bonds, debentures etc. They differ from each other in the following respects:

(1) Source of repayment : In the case of conventional securities, the primary source of repayment is the earning power and cash flow of the issuing company. But, under securitisation, the issuing company is completely free from this botheration since the burden of repayment is shifted to a pool of assets or to a third party.

(2) Structure : Under securitisation, the securities may be structured in such a way so as to achieve a desired level of risk and a desired level of rating depending upon the type and amount of assets pooled. Such a choice is not available in the case of conventional securities.

(3) Nature : In fact, these structured securities are basically derivatives of the traditional debt instruments. Of course, the credit standing of these securities is well supported by a pool of assets or by a guarantee or by both.

9.3 SECURITISATION VS. FACTORING

At this stage, one should not confuse the term ’securitisation’ with that of ‘factoring’. Since both deal with the assets viz., book debts and receivables, it is very

essential that the differences between them must be clearly understood. The main differences are :

(i) Factoring is mainly associated with the assets (book debts and receivables) of manufacturing and trading companies whereas securitisation is mainly associated with the assets of financial companies.

(ii) Factoring mainly deals with trade debts and trade receivables of clients. On the other hand, securitisation deals with loans and receivables arising out of loans like hire purchase finance receivables, receivables from Government department etc.

(iii) In the case of factoring, the trade debts and receivables in questions are short term in nature whereas they are medium term or long term in nature in the case of securitisation.

(iv) The question of issuing securities against book debts does not arise at all in the case of factoring whereas it forms the very basis of securitisation.

(v) The factor himself takes up the 'collection work' whereas it can be done either by the originator or by a separate servicing agency under securitisation.

(vi) Under factoring, the entire credit risk is passed on to the factor. But under securitisation, a part of the credit risk can be absorbed by the originator by transferring the assets at a discount.

9.4 MODUS OPERANDI OF SECURITISATION

For the operational mechanics of securitisation, the following parties are required:

(i) The originator

(ii) A Special Purpose Vehicle (SPV) or a trust

(iii) A merchant or investment banker

(iv) A credit rating agency

(v) A servicing agent-Receiving and Paying agent (RPA)

(vi) The original borrowers or obligors

(vii) The prospective investors i.e. the buyers of securities

The various stages involved in the working of securitisation are as follows :

(1) Identification stage/process

(2) Transfer stage/process

(3) Issue stage/process

(4) Redemption stage/process

(5) Credit Rating stage/process

1. Identification Process

The lending financial institution either a bank or any other institution for that matter which decides to go in for securitisation of its assets is called the 'originator'. The originator might have got assets comprising of a variety of receivables like commercial mortgages, lease receivables, hire purchase receivables etc. The originator has to pick up a pool of assets of homogeneous nature, considering the maturities, interest rates involved, frequency of repayments and marketability. This process of selecting a pool of loans and receivables from the asset portfolios for securitisation is called "identification process'.

2. Transfer Process

After the identification process is over, the selected pool of assets are then "passed through" to another institution which is ready to help the originator to convert those pools of assets into securities. This institution is called the special purpose vehicle (SPV) or the trust. The pass through transaction between the originator and the SPV is either by way of outright sale i.e. full transfer of assets in question for valuable consideration or by passing them for a collateralized loan. Generally, it is done on an outright sale basis. This process of passing through the selected poof of assets by the originator to a SPV is called transfer

process and once this transfer process is over, the assets are removed from the balance sheet of the originator.

3. Issue Process

After this transfer process is over, the SPV takes up the onerous task of converting these assets of various types of different maturities. It is on this basis, the SPV issues securities to investors. The SPV actually splits the package into individual securities of smaller values and they are sold to the investing public. The SPV gets itself reimbursed out of the sale proceeds. The securities issued by the SPV is called by different names like Pay through Certificates, Pass through Certificates, Interest only Certificate, Principal only Certificates etc. The securities are structured in such a way that the maturity of these securities may synchronies with the maturities of the securitised loans or receivables.

4. Redemption Process

The redemption and payments of interest on these securities are facilitated by the collections received by the SPV from the securitised assets. The task of collection of dues is generally entrusted to the originator of a special servicing agent can be appointed for this purpose. This agency is paid a certain percentage of commission for the collection services rendered. The servicing agent is responsible for collecting the principal and interest payments on assets pooled when due and he must pay a special attention to delinquent accounts. Usually, the originator is appointed as the servicer. Thus, under securitisation, the role of the originator gets reduced to that of a collection agent on behalf of the SPV, in case he is appointed as a collection agent. A pass through certificate may be either ‘with recourse’ to the originator or ‘without recourse’. The usual practice is to make it ‘without recourse’. Hence, the holder of a pass through certificate has to look to the SPV for payment of the principal and interest on the certificates held by him. Thus, the main task of the SPV is to structure the deal, raise proceeds by issuing pass through certificates and arrange for payment f interest and principal to the investors.

5. Credit Rating Process

Since the pass through certificates have to be publicly issued, they require credit rating by a good credit rating agency so that they become more attractive and easily acceptable. Hence, these certificates are rated at least by one credit rating agency on the eve of the securitisation. The issues could also be guaranteed by external guarantor institutions like merchant bankers which would enhance the credit worthiness of the certificates and would be readily acceptable to investors. Of course, this rating guarantee provides a sense of confidence to the investor with regard to the timely payment of principal and interest by the SPV.

Pass through certificates, like debentures, directly reflect the ownership rights in the assets securitised, their repayment schedule, interest rate etc. These certificates, before maturity, are tradable in a secondary market to ensure liquidity for the investors. They are negotiable securities and hence they can be easily tradable in the market.

Role of Merchant Bankers

Merchant or investment bankers can play a big role in asset securitisation. They generally act as Special Purpose Vehicle. There are many issues involved in securitisation namely the timing of the issue of pass through certificates, pricing of these certificates for marketing and above all underwriting of these issues. In private placement, they act as agents for the issuer connecting the sellers and buyers. They can also involve in structuring the issue to see that the issue meets all legal regulatory, accounting, tax and other requirements. In all these aspects, merchant bankers have a definite role to play. The mere fact that an issue has been underwritten by a popular merchant banker will add credit to that issue and it would become more attractive from the investor’s point of view. Thus, securitisation enlarges the activities of the merchant bankers too.

Role of Other Parties

The other parties in the game of securitisation are the original borrowers and the prospective investors. The original borrowers refer to those who have availed of the loan facilities from the lending institution i.e., the originator. They are also called obligors. Infact the success of the securitisation process depends upon these original borrowers. If they fail to meet their commitments on the due dates, the securitisation process will be at danger. Infact the receipts of cash flows from the original borrowers are passed through to the investors. The prospective investors are nothing but the public at large who are willing to purchase the pass through certificates.

9.5 STRUCTURE FOR SECURITISATION/TYPES OF SECURITIES

Securitisation is a structured transaction, whereby the originator transfers or sells some of its assets to a SPV which breaks these assets into tradable securities of smaller value which could be sold to the investing public. The appropriate structure for securitisation depends on a variety of factors like quality of assets securitised, default experience of original borrowers, amount of amortisation at maturity, financial reputation and soundness of the originator etc. The general principle is that the securities must be structured in such a way that the maturity of these securities may coincide with the maturity of the securitised loans. However, there are three important types of securities as listed below:

(i) Pass through and pay through certificates

(ii) Preferred stock certificates and

(iii) Asset based commercial papers.

Pass through and pay through certificates

In the case of pass through certificates, payments to investors depend upon the cash flow from the assets backing such certificates. In other words, as and when cash (principal and interest) is received from the original borrower by the SPV, it is passed on

to the holders of certificates at regular intervals and the entire principal is returned with the retirement of the assets packed in the pool. Thus, pass through certificates have a single maturity structure and the tenure of these certificates is matched with the life of the securitised assets.

One the other hand, pay through certificates have a multiple maturity structure depending upon the maturity pattern of underlying assets. Thus, two or three types of securities with different maturity patterns like short term, medium term and long term may be issued. The greatest advantage is that they can by issued depending upon the investor's demand for varying maturity patterns. This type is more attractive from the investor's point of view because the yield is often inbuilt in the price of the securities themselves i.e. they are offered at a discount to face value as in the case of deep-discount bonds.

Preferred stock certificates

Preferred stocks are instruments issued by a subsidiary company against the trade debts and consumer receivables of its parent company. In other words, subsidiary companies buy the trade debts and receivables of parent companies, convert them into short term securities, and help the parent companies to enjoy liquidity. Thus trade debts can also be securitised through the issue of preferred stocks. Generally, these stocks are backed by guarantees given by highly rated merchant banks and hence they are also attractive from the investor's point of view. These instruments are mostly short term in nature.

Asset-based commercial papers

This type of structure is mostly prevalent in mortgage backed securities. Under this type, the SPV purchases portfolio of mortgages from different sources (various lending institutions) and they are combined into a single group on the basis of interest rates, maturity dates and underlying collaterals. They are, then, transferred to a Trust which, in turn, issues mortgage backed certificates to the investors. These certificates are

issued against the combined principal value of the mortgages and they are also short term instruments. Each certificate holder is entitled to participate in the cash flow from underlying mortgages to the extent of his investments in the certificates.

Other types

Apart form the above, there are also other types of certificates namely :

(i) Interest only certificates and

(ii) Principal only certificates

In the case of Interest only certificates, payments are made to investors only from the interest incomes earned from the assets securitised. As the very name suggests, payments are made to investors only from the repayment of principal by the original borrows, in the case of principal only certificates. These certificates enable speculative dealings since the speculators know well that the interest rate movements would affect the bond values immediately. For instance, the principal only certificates would increase in value when interest rates go down. It is so because, it becomes advantageous to repay the existing debts and resort to fresh borrowings at lower cost. This early redemption of securities would benefit the investors to a greater extent. Similarly, when the interest rates go up, interest only certificate holders stand to gain since more interest would be available from the underlying assets. One cannot exactly predict the future movements of interest, and hence, these certificates give much scope for speculators to play their game.

Thus, securitisation offers much scope for the introduction of newer and newer instruments so as to meet the varying requirements of investors. Debt securitisation offers a variety of investment instruments to the investing public at large as well as to the financial intermediaries like mutual funds, insurance companies etc.

9.6 SECURITISABLE ASSETS

As stated earlier, all assets are not suitable for securitisation. For instance, trade debts and receivables are not generally suitable for securitisation whereas they are readily

acceptable to a factor. Only in rare cases, they are securitised. The following assets are generally securitised by financial institutions :

(i) Term loans to financially reputed companies

(ii) Receivables from Government Departments and Companies

(iii) Credit Card receivables

(iv) Hire purchase loans like vehicle loans

(v) Lease Finance

(vi) Mortgage Loans etc.

9.7 BENEFITS OF SECURITISATION

Debt securitisation provides many benefits to all the parties, such as, the originator, investors and the regulatory authorities. Some of the important benefits are the following:

(i) Additional Source of Fund

The originator (i.e. the lending institution) is much benefited because securitisation provides an additional source of funds by converting an otherwise illiquid asset into ready liquidity. As a result, there is an immediate improvement in the cash flow of the originator. Thus, it acts as a source of liquidity.

(ii) Greater Profitability

Securitisation helps financial institutions to get liquid cash from medium term and long term assets immediately rather than over a longer period. It leads to greater recycling of funds which, turn, leads to higher business turnover and profitability. Again, the cash flow could be recycled for investment in higher yielding assets. This means greater profitability. Moreover, economies of scale can be achieved since securitisation offers scope for the fuller utilization of the existing capabilities by providing liquid cash immediately. It results in additional business turnover.

Again, the originator can also act as the receiving and paying agent. If so, it gets additional income in the form of servicing fee.

(iii) Enhancement of Capital Adequacy Ratio

Securitisation enables financial institutions to enhance their capital adequacy ratio by reducing their assets volume. The process of securitisation necessitates the selection of a pool of assets by the financial institutions to be sold or transferred to another institution called SPV. Once the assets are transferred, they are removed from the balance sheet of the originator. It results in the reduction of assets volume, thereby increasing the capital adequacy ratio. Capital adequacy ratio can also be improved by replacing the loan assets with the lesser risk weighted assets. Thus, the removal of assets from the Balance Sheet under a true sale improves the capital adequacy norms.

(iv) Spreading of Credit Risk

Securitisation facilities the spreading of credit risk to different parties involved in the process of securitisation. In the absence of securitisation, the entire credit risk associated with a particular financial transaction has to be borne by the originator himself. Now, the originator is able to diversify the risk factors among the various parties involved in securitisation. Thus, securitisation helps to achieve diversification of credit risks which are greater in the case of medium term and long term loans. Thus, it is used as tool for risk management.

(v) Lower Cost of Funding

In view of enhancement of cash flows and diversification of risk factors, securitisation enables the originator to have an easy access to the securities market. It means that companies with low credit rating can issue asset backed securities at lower interest cost due to high credit rating on such securities. This helps it to secure funds at lower cost. Moreover, the criteria for choosing the pool

of assets ensures an efficient cost of funds. In the present context of scarcity of funds and higher interest rates, securitisation provides a good scope for cheap funding.

(vi) Provision of Multiple Instrument

From the investor's point of view, securitisation provides multiple new investment instruments so as to meet the varying requirements of the investing public. It also offers varieties of instruments for other financial intermediaries like mutual funds, insurance companies, pension funds etc. giving them many choices.

(vii) Higher Rate of Return

When compared to traditional debt securities like bonds and debentures, securitised securities offer better rate of return along with better liquidity. These instruments are rated by good credit rating agencies and hence more attractive. Being structured assets based securities, they offer more protection and yield a good return. The bankruptcy/winding up of the originator does not affect the investors since the payment is guaranteed by the SPV.

(viii) Prevention of Idle Capital

In the absence of securitisation, capital would remain idle in the form of illiquid assets like mortgages, term loans etc., in many of the lending institutions. Now, securitisation helps recycling of funds by converting these assets into liquidity, liquidity into assets, assets into liquidity and so on by means of issuing tradable and transferable securities against these assets. Thus, it provides impetus for capital formation.

(ix) Better than Traditional Instruments

Certificates are issued to investors against the backing of assets securitised. The underlying assets are used not only as a collateral to the certificates but also to generate the income to pay the principal and interest to the investors. It does not

entail any servicing needs and hence does not require much costs. It is better than even mutual fund units because it is issued against the backing of collateral securities whereas there is no such backing for mutual fund certificates. Thus, these instruments, being structured asset backed securities, afford a greater protection to investors.

Again, there is much transparency from the investor's point of view. They can very well see the collateral pool that a particular issue represents and this transparency reduces uncertainty as to the risk element.

(x) Other Benefits

Securitisation, if carried out in true spirit, leads to greater economy in the use of capital with efficiency and cost effectiveness in both funding and lending. This is a great boon to the regulating authorities as well since their primary objective is to prevent the accumulation of capital where it is not needed.

In the long run, it is beneficial to the borrowers also. They will be able to get funds at cheaper rates since the originators are likely to pass on the benefit to the ultimate borrows. There is no doubt that securitisation is a low cost and innovative funding source ensuring economy in the use of capital.

9.8 SECURITISATION AND BANKS

There is a vast scope for commercial banks to go in for securitisation due to the following factors:

(i) Innovative and low cost source of fund

Traditionally deposit has been the only dependable source of funds for banks over the years. But, in recent times, banks have to face severe competition from other non-banking institutions in deposit mobilization. Now, securitisation offers an excellent source of funds at cheaper rates. Unlike deposits, it will not entail any servicing needs and the consequent increase in costs.

(ii) Better capital adequacy norms

Securitisation has the effect of improving the capital adequacy norms of banks. Generally, commercial firms utilize the cash flow from securitisation for repayment of their borrowings, and thus, they can achieve a good debt-equity ratio. But, in the case of banks, borrowings are limited. So they can better utilize the cash flow to create lower risk weighted assets. Hence, high risk weighted assets can be easily converted into lower risk weighted assets. Thus, it helps banks to achieve better capital adequacy norms.

(iii) Creation of more credit

In India, banks are subject to high statutory pre-emptions for which more liquid cash is essential now and then. This has necessarily impaired the capacity of banks to create credit. Infact, securitisation is not at all affected by these factors. The cash flow from securitisation could be very well used for further expansion of credit without any statutory restrictions.

(iv) Increased Profitability

The profitability of banks has been very much affected to a greater extent in these days due to many factors. In this context, securitisation has a salutary impact on the profitability of banks. It provides for more liquidity, quicker recycling of funds and greater economy in the use of capital. This has the effect of improving the profitability of banks. Besides, they can also earn income in the form of service fee by acting as receiving and paying agent.

(v) Tool for Asset-liability Management and Risk Management

Securitisation can be better used as a tool to avoid mis-match in the asset-liability management. It would reduce the over dependence of banks on the market for money at call and short notice as well as the refinancing agencies for recycling of funds. Again, it can be used as a risk management tool also. It completely

eliminates the interest risk and thus it provides a hedge to banks against interest risk which are inherent in the free interest rate market.

9.9 CONDITIONS FOR SUCCESSFUL SECURITISATION

If securitisation of debt has to be successful, the following conditions must have been fulfilled :

(i) Ultimately, the success of securitisation depends upon the ability of the original borrower to repay his loan. Therefore, selection of assets to be securitised requires utmost care. The assets should be ranked and selected on the basis of least losses and to provide for maximum protection to the investor.

(ii) The credit rating is an integral part of securitisation. Hence, credit rating must be done by credit rating agencies on a scientific basis and the ratings should be unquestionable. Then only the prospective investor's confidence can be built. The credit rating agencies should take into account the various types of risks such as credit risk, interest risk, liquidity risk etc. along with other usual factors.

(iii) The SPV should be a separate organization from that of the originator. It should be completely insulted from the parent corporate entity so that SPV could be protected from the danger of bankruptcy.

(iv) The pass through certificates or any other similar instruments arising out of securitisation must be listed in stock exchanges so that they may be readily acceptable to investors. It would provide instant liquidity and moreover, its price could also be easily ascertained.

(v) Alternatively, it is also advisable to provide two-way quotations for facilitating the buying and selling of the pass through certificates in the market as in the case of mutual fund units.

(vi) There must be standardized loan documentation for similar loans so that there may be uniformity between different financial institutions. It must carry a right to assign debts to third parties, so that, it could be sold or transferred to the SPV.

(vii) There should be a proper accounting treatment for the various transactions involved in asset securitisation. Suitable accounting norms for the reorganisation of the trust created for securitised debt should be evolved. The accounting system should provide for the removal of the securitised assets from the balance sheet of the originator. Only then, the real benefit will go to the originator.

(viii) Above all, there should be proper and adequate guidelines given by the regulatory authorities dealing with the various aspects of the process of securitisation.

9.10 SECURITISATION ABROAD

The credit of introducing the concept of securitisation goes to America where the first structured asset securitised financing came into being in 1970. In 1970, the newly created Government National Mortgage Association (Ginnie Mae) began its operations by publicly trading in securities, backed by a pool of mortgage loans. It was followed by Federal National Mortgage Association and similar organizations. These organizations bought residential mortgage loans, made pools out of them and issued mortgage-backed securities against them. The payment of principal and interest of these instruments was also guaranteed. The securities issued by it were called “Mortgage pass through securities”. A pool of mortgage was created by putting together assets that had similar characteristics in terms of duration, interest rate and quality. The pool was then placed with a trust which actually sold the certificates drawn against such mortgages to the investors either directly or through private placement. Thus, the concept of securitisation was confined to mortgages only.

However, in March 1985, non-mortgage collaterals started getting securitised in the U.S.A.. For instance, the first offering of 192 million of lease backed certificates for Sperry lease Finance Corporation was underwritten by The First Boston. Now it has become a popular mode of financing in America. It is slowly becoming a global phenomenon covering transactions relating to various modes of finance.

Securitisation is gaining popularity in the U.K. also in recent years only. Like America, this concept started with mortgage securitisation. The Bank America Finance Ltd., U.K. issued mortgage securities in January, 1985 against the residential property mortgages as underlying assets. The first mortgage securitisation issue for the international market arranged was MINI in London in 1985. Now, clearing banks and buildings societies have entered into this market under the supervision of the Bank of England. Securitisation of debt and the consequent debt instruments are now popular in countries like Italy, Australia, Canada, France, Spain, and Japan. In many of these countries, the process of securitisation has been encouraged by passing suitable legislations.

9.11 SECURITISATION IN INDIA

The concept of asset securitisation is slowly entering into the Indian soil. Financial institutions have not yet come forward to make use of this avenue for financing on a large scale. However, there is a tardy movement of the financial institutions in resorting to this mode of financing. The securitisation of the ICICI's receivables by the Citibank in February 1991 is the first attempt in this direction. A sum of Rs.15 crores was raised by means of securitisation of assets. Following this, the hire purchase portfolio of TELCO was securitised by the Citibank. Again, the Retail Residential Receivables of DLF International were also securitised by the Citibank in June 1992. The Citibank's own portfolio of "Citimobile Scheme" was subject to securitisation. Infact the Citibank has pioneered this trend in India. Now, the HDFC has taken up this route along with the Citibank. The HDFC is on the way to securities its housing loan portfolio around Rs.50

crores. Infrastructure Leasing and Financial Services has entered into this field by setting up a SPV. If securitisation has to become popular in India, the commercial banks should enter into this field in a big way. Infact, the commercial banks can remove the non-performing assets from their balance sheet by resorting to this technique. At the same time, they can recycle the funds for greater profitability. If financial institutions have to meet their ever-increasing capital requirements, securitisation would go a long way in mobilizing adequate resources.

9.12 CAUSES FOR THE UNPOPULARITY OF SECURITISATION IN INDIA

Though securitisation brings many benefits, it is not firmly rooted in Indian soil due to the following reasons:

(i) New Concept

Securitisation itself is a new concept in debt market. There is much unawareness not only among the investors but also among the various financial intermediaries. Though securitisation brings immediate benefits to the lending institutions, most of them neither aware of this concept nor its advantages.

(ii) Heavy Stamp duty and Registration Fees

Basically, securitisation requires the transfer of various illiquid and non-performing assets to a central agency called Special Purpose Vehicle. This transfer involves heavy stamp duty and registration fee. These costs are so exorbitant that people are automatically discouraged to go in for this innovative technique of financing.

(iii) Cumbersome Transfer Procedures

Again, the transfer of assets involves very complicated and cumbersome legal procedures which stand as a real impediment in the way of securitisation.

(iv) Difficulty in Assignment of Debts

The right to assign debts to third parties has been permitted only under certain circumstances under the Transfer of Property Act and infact, this transfer/sale of debts forms the central theme of securitisation. Hence, the Transfer of Property Act should be suitably amended so as to facilitate securitisation in India.

(v) Absence of Standardized Loan Documentation

As it is, there is no standardized loan documentation procedure in India. There is no uniformity between different financial institutions regarding the loan documentation even for the same type of loans. In such a case, it becomes very difficult for an agency like the Special Purpose Vehicle to pool the similar assets of the various financial institutions for securitisation.

(vi) Inadequate Credit Rating Facilities

Credit rating is an integral part of securitisation. Unfortunately, credit rating in India is at its infancy level. Now only, it becomes obligatory to get credit rating for all debt instruments issued by non-banking companies. The credit rating agencies are not adequately available in India at present to take up the stupendous task of credit rating instruments for securitisation purposes. However, a good progress has been made in this direction in recent times.

(vii) Absence of Proper Accounting Procedures

Proper accounting procedure should be evolved for securitisation. Creation of a Trust or Special Purpose Vehicle is a must for securitisation and as such there is no accounting procedure for the recognition of this trust. Again, securitisation paves way for the removal of the securitised assets from the Balance sheet of the originator. How should one account for it? It is a challenge to the accounting professionals in the country to evolve suitable accounting procedures for securitisation.

(viii) Absence of Proper guidelines

One can find a lot of guidelines issued by the Regulatory authorities to deal with mutual funds, non-banking companies etc. But, they are conspicuously absent in the field of securitisation. There are various processes involved in securitisation right from the identification process to the redemption process. Again, various types of structures are available. Hence, proper guidelines must be issued covering all these aspects so that financial intermediaries can go for securitisation without any hesitation and thus securitisation becomes a smooth affair.

There is a bright future for securitisation in India due to the following factors :

(i) With the liberalization of the financial markets, there is bound to be more demand for capital.

(ii) There has been an explosive growth of capital market and a vast increase in the investor base in recent times.

(iii) The entry of newer financial intermediaries like mutual funds, money market, pension funds etc. has paved the way for floating debt instruments easily in the market.

(iv) Debt instruments have become popular in recent times since corporate customers are not willing to take recourse to the equity route as a major source of financing their projects.

(v) There is a proposal to establish Asset Reconstruction Fund as per the Narasimhan Committee recommendations for the purpose of securitisation of non-performing assets.

(vi) Since the financial institutions and banks have to follow the capital adequacy norms as recommended by the Narasimhan Committee, they have to necessarily go for securitisation.

The above factors clearly indicate that there is a vast scope for the introduction of the concept of securitisation of assets on a large scale as an innovative step for resource

mobilization. More than that, it is used as a tool to improve the balance sheets by bringing out changes in the critical financial ratios like debt-equity ratio, return on assets ratio, asset turnover ratio, capital adequacy ratio etc.

There is much scope for securitisation in respects of loans under (i) mortgage (ii) housing loans (iii) other term loan and (iv) credit and receivables.

In the case of non-banking financial companies also, lease receivables and vehicle loans could be readily securitised. With nearly Rs.70,000 crore outstanding corporate debts of financial institutions, at least Rs.50,000 crore could be securitised and thereby the financial institutions could raise their liquidity for greater profitability.

While most of the innovations in the financial service industry directly benefit the customers, these innovations like factoring and securitisation directly bring benefits to the financial institutions themselves first and then to the public at large. It is high time that the Government came forward with all positive help to encourage securitisation in India.

The immediate need of the hour is to amend the various relevant Act like the Transfer of Property Act, 1882, the Registration Act 1908, Stamp Laws Act 1809 etc. to make asset securitisation a smooth affair. Proper accounting procedures should be evolved besides appropriate guidelines by the regulatory authorities. Securitisation would facilitate the transfer of capital from non-performing and idle assets to more efficient assets. Creation of new debt instruments would further deepen the financial market. On the whole, the economy would be developed at a faster rate than what it is, if securitisation becomes a popular technique of financing. Since the stamp duties have been considerably reduced in any states and the National Stock Exchange has decided to list securitised assets, securitisation is expected to have a very bright future in India and the debt market is expected to become very active in the days to come.

9.13 SUMMARY

A technique whereby assets are converted into securities, which are in turn converted into cash on an ongoing basis, with a view to allow for increasing turnover of business and profit, is known as asset securitization. The technique provides for flexibility in yield, pricing pattern, issue risk and marketability of instruments, to the advantage of both borrowers and lenders. There are many features to securitization such as marketability of financial claims, wide distribution, homogeneity, etc. Securitized financial instruments are useful as they help small investors by facilitating liquidity. An entity called ‘Special Purpose Vehicle’ acts as an intermediary between the originator of the receivables and the end-investors. It also plays an active role in reinvesting or reshaping the cash flows arising from the assets transferred to it. It helps improve the return on capital, as it normally requires less capital to support as compared to traditional on balance sheet funding. Similarly, it also helps in raising finance when other forms of finance are unavailable, besides being helpful in reducing credit exposure, etc. Securitization is beneficial in many ways. For instance, it facilitates off-balance sheet financing. In addition, it also helps firms access the market for low-cost credit. However, the process may cause a diminution in the importance of banks in the financial intermediation process. Similarly, it may also cause heightened volatility in asset values by allowing the transformation of non-liquid loans into liquid securities. A well-developed capital market allows for the smooth growth of securitization.

9.14 KEYWORDS

Securitization: A technique whereby assets are converted into securities, which are in turn converted into cash on an ongoing basis, with a view to allow for increasing turnover of business and profit, is known as securitization.

Asset Backed Security: Securitization refers to the transformation of illiquid, risky individual loans into more liquid, less risky securities referred to as asset-backed securities.

Special Purpose Vehicle: Financial intermediary involved in re-engineering the cash flow could be a trust or a corporation.

9.15 SELF ASSESSMENT QUESTIONS

1. Define debt securitisation and discuss its modus operandi.
2. Discuss the various structure available for securitisation. Which structure is suitable to Indian condition?
3. Trace out the development in the filed of securitisation in abroad and in India and discuss its future prospects in India.
4. What are the various benefits of securitisation?

9.16 SUGGESTED READINGS

Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

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Class	**:**	**MBA**	**Updated by :**	**Dr. M.C. Garg**
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LESSON-10

HOUSING FINANCE

STRUCTURE

10.0 Objective

10.1 Introduction

10.2 National Housing Bank

10.3 Housing Finance System

10.4 New Developments

10.5 Summary

10.6 Keywords

10.7 Self Assessment Questions

10.8 Suggested Readings

10.0 OBJECTIVE

After reading this lesson, you will be able to:

(a) Trace the role being played by National Housing Bank

(b) Appreciate the institutional framework of housing finance.

(c) Discuss the new developments that have taken place in housing finance in India.

10.1 INTRODUCTION

Housing is one of the basic necessities of man, and the capital required per dwelling is so large that few individuals can raise it from their own savings. There is therefore a great need and scope for the development of arrangements for supplying loans

or finance for the purpose of house construction. However, for some reason or other, the shelter sector of the Indian financial system remained utterly underdeveloped till the end of the 1980s. The lack of adequate institutional supply of credit for house building was stressed as an important gap in the process of financial development in India. In the recent past, the authorities have initiated certain steps to bridge this gap.

Finance for housing is provided in the form of mortgage loans, i.e., it is provided against the security of immoveable property of land and buildings. The suppliers of house mortgage loans in India are the following: the Housing and Urban Development Corporation (HUDCO), the apex Co-operative Housing finance Societies and Housing Boards in different states, central and state governments, LIC, Commercial banks, GIC, and a few private housing finance companies and *nidhis*. The governments provide direct loans mainly to their employees. The participation of commercial and urban co-operative banks in direct mortgage loan has been marginal till recently. The LIC has been a major supplier of mortgage loans in indirect and direct forms. It has been giving loans for house building to the state governments, apex Co-operative Housing Finance Societies, HUDCO, and so on. In addition, it has been providing mortgage loans directly individuals under its various mortgage schemes.

10.2 NATIONAL HOUSING BANK

It was set up in July 1988 as an apex level housing finance institution and as a wholly owned subsidiary of the RBI. It began its operations with a total capital of Rs.170 crore (Rs.100 crore as share capital, Rs.50 crore as long-term loan from the RBI, and Rs.20 crore through the sale of bonds). In September 1989, its share capital was raised to Rs.150 crore. During 1989-90, it issued its second series of bonds to which the total subscription amounted to Rs.60 crores. These bonds were guaranteed by the central government and had carried an interest rate of 11.5 per cent per annum. The RBI had sanctioned in 1989-90 a long term loan of Rs.25 crore to it. Further, it can borrow in the U.S. capital market $50 million under the USAID Government Guarantee programme. In

1995-96, the paid up and authorized capital of NHB was raised to Rs.300 crore with an additional capital contribution of Rs.50 crore by the RBI. Thus, the resources base of the NHB has been made quite strong.

10.2.1 Business of NHB

Subject to the provisions of the NHB Act, the NHB is authorized to transact all/any of the following kinds of business.

(a) Promoting, establishing, supporting/aiding in the promotion/ establishment/ support of housing financing institutions (HFIs);

(b) Making of loans and advances or rendering any other form of financial assistance, whatsoever, for housing activities to HFIs, banks, state cooperative, agricultural and rural development banks or any other institution/class of institutions notified by the Government;

(c) Subscribing to/purchasing stocks, shares, bonds, debentures and securities of every other description;

(d) Guaranteeing the financial obligations of HFIs and underwriting the issue of stocks/shares/bonds/debentures/other securities of HFIs;

(e) Drawing, accepting, discounting/rediscounting, buying/selling and dealing in bills of exchange promissory notes, bonds/debentures, hundies, coupons/other instruments;

(ea) Buying/selling, or otherwise dealing in any loans/advances secured by mortgage/charge of immoveable property relating to banks/HFIs;

(eb) Creating trust(s) and transferring loans/advances together with/without securities there from to HFIs for a consideration;

(ec) Setting aside loans/advances held by the NHB and issuing/selling securities based upon them in the form of debt obligations/trust certificates of beneficial interest/other instruments, and to act as trustee for the holders of such securities;

(ed) Setting up of mutual funds of undertaking housing finance activities;

(ee) Undertaking/participating in housing mortgage insurance;

(f) Promoting/forming/conducting or associating in promotion/ formation/ conduct of companies/mortgage banks/subsidiaries/societies/trusts/other associations of persons it may deem fit for carrying out all/any of its functions under the NHB Act;

(g) Undertaking research and surveys on construction techniques and other studies relating to/connected with shelter/housing and human settlement;

(h) Formulating scheme(s) for purpose of mobilization of resources and extension of credit for housing;

(i) Formulating scheme(s) for the economically weaker sections of society, which may be subsidized by the Government or any other source;

(j) Organising training programmes/seminars/symposia on matters relating to housing;

(k) Providing guidelines to HFIs to ensure their growth on sound lines;

(l) Providing technical/administrative assistance to HFIs;

(m) Coordinating with the Life Insurance Corporation of India, the Unit Trust of India, the General Insurance Corporation of India and other financial institutions, in the discharge of its overall functions;

(n) Exercising all powers and functions in the performance of duties entrusted to it under the NHB act or under any other law in force for the time being;

(o) Acting as agent of the Central/State Government/the RBI or of any authority as may be authorized by the RBI;

(p) Any other kind of business which the Government may, on the recommendations of the RBI, authorize;

(q) Generally, doing of all such matters and things as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under the NHB act.

Borrowing and Acceptance of Deposits

For purposes of carrying out its functions, the NHB may :

(a) issue and sell bonds and debentures with or without the guarantee of the Central Government, in such manner and on such terms as may be prescribed;

(b) borrow money from the Central Government, banks, financial institutions, mutual funds and from any other authority or organization or institution approved by the Government on such terms and conditions as may be agreed upon;

(c) accepting deposits repayable after such period and on such terms as may generally or specially be approved by the RBI;

(d) borrow money from the RBI (i) by way of loans and advances and, generally, obtain financial assistance in a manner specified by the RBI; (ii) out of the National Housing Credit (long-term operations) Fund established under Section 46-D of the RBI Act;

(e) receive, for services rendered, remuneration, commission, commitment charges, consultancy charges, service charges, royalties, premium, licence fees and other considerations of any description;

(f) receive gifts, grants, donations or benefactions from the Government or any other source.

The Central Government may guarantee the bonds and debentures issued by the NHB as to the repayment of the principal and the payment of interest at rate(s) fixed by the Government.

The explicit and primary aim of the NHB is to promote housing finance institutions at local and regional levels in the private and joint sectors by providing financial and other support to such institutions. It refinances housing loans under its refinance schemes for scheduled commercial and co-operative banks, housing finance companies, apex co-operative housing finance societies, and so on. It extends financial support to SLDBs in respect of their housing loans through subscription of Special Rural Housing Debentures floated by them. One hundred per cent refinance is given by it in respect of direct loans upto Rs.1 lakh. Its objective is to limit the floor space of dwellings to a reasonable size. Its refinance is available for 15 to 20 years. There were 22 HFCs which were approved by the NHB for the purpose of receiving refinance.

The NHB has taken steps to augment real resources also for housing by extending term loans at market rates of interest for land development projects to be completed within a specified time limit, viz., two years or so. It also supports industries that augment supplies of building materials so as to lower the construction cost.

To provide loans directly to individuals for enabling them to own houses is, of course, one of its main activities. For this purpose, it has started a flexible, convenient, special loan-linked saving plan known as Home Loan Account Scheme (HLAS). The basic idea behind this scheme is that prospective house owners should save in advance of the decision to acquire a house. All-India scheduled commercial banks, scheduled State Co-operative banks, and scheduled urban co-operative banks are participating in the implementation of the scheme. The ceiling of Rs.3 lakh on the housing loan under the scheme imposed earlier has now been removed, but loans above Rs.2 lakh will be limited to 1.5 times the accumulated savings.

10.3 HOUSING FINANCE SYSTEM

The implementation of housing finance policies presupposes efficient institutional arrangements. Although there were a large number of agencies providing direct finance to individuals for house construction, there was no well established finance system till the

mid-eighties in as much as it had not been integrated with the main financial system of the country. The setting-up of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India, as an apex institution was the culmination of the fulfillment of a long overdue need of the housing finance industry in India. The system has also been characterized by the emergence of several specialised financial institutions that have considerably strengthened the organization of the housing finance system in the country. At present, there are about 320 housing finance companies, of which 26 are registered with the NHB and which account of 98 per cent of the total housing loan disbursed. A brief account of some of the institutions/agencies is given below :

Central and State Governments

Till the mid-eighties, the responsibility to provide housing finance rested, by and large, with the government. The Central and State Government indirectly support the housing building effort. The Central Government has introduced, from time to time, various social housing schemes. The role of the Central Government vis-à-vis these scheme is confined to laying down broad principles, providing necessary advice and rendering financial assistance in the form of loans and subsidies to the state governments and union territories. The Central Government has set up the Housing and Urban Development Corporation (HUDCO) to finance and undertake housing and urban development programmes, development of land for satellite towns, besides setting up of a building materials industry.

The Central Government provides equity support to the HUDCO and guarantees the bonds issued by it. Apart from this, both Central and state governments provide house building advances to their employees. While the Central Government formulates housing schemes, the State Governments are the actual implementing agencies.

Housing and Urban Development Corporation (HUDCO)

Objectives : HUDCO was established on 25th April 1970, as a fully owned Government of India enterprise, with the following objectives :

(i) To provide long-term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country.

(ii) To finance or undertake the setting-up of new satellite towns.

(iii) To finance or undertake the setting-up of the building materials industries.

(iv) Administer the monies received, from the Government of India and other such grants, for purposes of financing or undertaking housing and urban development programmes.

(v) To subscribe to the debentures and bonds to be issued by the state housing boards, improvement trusts, development authorities and so on, specifically for the purpose of financing housing and urban development programmes.

In brief, the principal mandate of the HUDCO was to ameliorate the housing conditions of the low income group (LIG) and economically weaker sections (EWS).

Resource Base : The HUDCO was established with an equity base of Rs.2 crore. Over the years, the equity base has been expanded by the Government. It has further been able to mobilize resources from institutional agencies like LIC, GIC, UTI, banks, international assistance (Kfw, OECF, ODA, USAID), as well as through public deposits.

Form of Assistance : The HUDCO extends assistance, benefiting masses in urban and rural areas, under a broad spectrum of programmes of housing, infrastructure, consultancy services and training.

Urban Infrastructure : The HUDCO has also been entrusted with the responsibility of financing urban infrastructure projects with additional equity support provide by the Ministry of Urban Development, Government of India. The infrastructure projects cover sectors of water supply, sewerage, drainage, solid waste management, transport nagars/terminals, commercial and social infrastructure, roads/bridges, area development projects and so on.

The HUDCO plans to stress, in future, on expansion of urban infrastructure lending, housing delivery through expanded avenues including retail financing, increased consultancy assistance, services for projects in India and abroad, impetus to building, technology transfer initiatives and in-house research and training programmes with national/international working.

Insurance Organisations/Corporations

The LIC and GIC support housing activity both directly and indirectly. Besides subscribing to bonds of the HUDCO and state housing boards, LIC grants loans to the states for their rural housing programmes and to public sector companies for construction of staff quarters. Though the LIC has been granting loans directly to individuals, the thrust to housing finance was provided when, in June 1989, the LIC promoted a subsidiary for the purpose, namely the LIC Home Finance Ltd.

The GIC supports housing almost exclusively, indirectly, by subscribing to bonds/debentures floated by the HUDCO and state housing boards. It has also set up a housing finance subsidiary called the GIC Housing Finance Ltd. in July 1990, to enable it to lend directly to individuals.

Commercial Banks

The trend of commercial banks lending to individuals for housing emerged in the wake of the report of the working group on the Role of Banking System in Providing Finance for Housing Schemes (R C Shah Working Group, the RBI, 1978). They have been lending to the housing sector based on annual credit allocations made by the RBI. In terms of the RBI guidelines, scheduled commercial banks are required to allocate 1.5 per cent of their incremental deposits for disbursing as housing finance every year. Of this allocation, 20 per cent has to be by way of direct housing loans of which again at least half, that is, 10 per cent of the allocation has to be in rural and semi-urban areas. Another 30 per cent could be for indirect lending by way of term loans to housing finance institutions (HFIs), housing finance companies (HFCs) and public housing agencies for

the acquisition and development of land and to private builders for construction. The balance 50 per cent is for subscription to the HUDCO, and the NHB bonds.

Cooperative Banks

The cooperative banking sector consists of state cooperative banks (SCBs), district central cooperative banks (DCBs) and primary urban cooperative banks (PUCBs). The first set of comprehensive guidelines for these cooperative banks were issued in 1984 by the RBI. Cooperative banks finance individuals, cooperative group housing societies, housing boards and others who undertake housing projects for the EWS, LIGs, and MIGs.

SHFSs

The State Housing Finance Societies (SHFSs) constitute another major source of funds in the residential mortgage market. These societies advance loans to the affiliated Primary Cooperative Housing Societies for construction of dwelling houses, purchase of land, additions and improvements to existing houses, purchase of house, and repayment of earlier mortgage debt. The terms and conditions of loans vary somewhat from state to state; they also vary with the location of the house, the borrower's income group, and the purpose of loan within the state. The maximum amount of a loan varies between 65 to 80 per cent of the value of land and buildings, or some specified maximum amount, whichever is lower. The amount of loan is also linked with the primary society's shareholding in the apex society. The maturity period varies from 15 to 30 years, but 20 to 25 years is more common. The rate of interest charged is linked with the bank rate, and/or the respective society's own borrowing rate. In most cases the rate charged is the bank rate plus 3 per cent or the borrowing rate plus 1 to 3 per cent. The mortgages are annuity mortgages with equal monthly or quarterly installments of repayment during the life of the mortgage. However, sometimes half yearly or annual instalments are also made. The major sources of funds for these institutions are: (a) investment in their share capital by the Government and cooperative institutions; (b) Loans from the Government

and LIC; (c) fixed deposits from individuals and institutions; (d) issue of debentures guaranteed by the Government.

HDFC

The Housing Development Finance Corporation Ltd. (HDFC) has been playing an important role in meeting housing finance requirements. The HDFC was set up in 1977 by the ICICI out of the consideration that a specialised institution was needed to channel household savings as well as funds from the capital market into the housing sector. It works through branch and representative offices. HDFC's loans were linked up with planned saving. Given the sum needed for a house, a part of it has to be in the form of saving contribution, and the rest was given by the HDFC in the form of a loan. While the saving part was 30 per cent, the loan portion was 70 per cent of the cost of the house. It discontinued home saving plan scheme from March 1993 because it had become unviable.

The sources of funds for the HDFC are : deposits collected through various deposit schemes, domestic long-term funds from commercial banks and financial institutions, long-term loans from international institutions such as the World Bank and United States Agency for International Development (USAID), and HDFC 10 year bonds.

10.4 NEW DEVELOPMENTS

Recently, some very important developments have taken place in the filed of housing finance in India. They are: (1) the entry of the LIC in a major way in the direct household mortgage loan originations, (2) the entry of the commercial banking system in direct loan origination process, (3) the major initiatives by commercial banks to create housing finance subsidiaries along with the existing housing finance institutions or on their own, (4) the entry of GIC in the home loan origination process through a subsidiary, (5) the co-promotion of two regional housing finance companies by the UTI (one with the SBI for the Eastern region, and other with the Canara Bank of the Southern region), (6)

the floatation of Housing and Construction Investment Fund (1989) by the UTI for direct investment in construction project finance and real estate development, (7) the liberalization of guidelines by the RBI regarding supply of housing loans by commercial banks, and (8) the establishment of the National Housing Bank in July 1988.

As in other fields, the RBI has been actively involved in developing a sound and healthy institutional system for the provision of housing finance also. A committee appointed by the RBI under the chairmanship of C. Rangarajan had recommended an institutional set-up for housing finance comprising (a) regional and local level institutions (companies) in the public and private sectors for mobilizing household sector savings and providing home loans, and (b) a national level apex housing finance institution primarily to promote base level institutions, to co-ordinate the activities of institutions providing housing finance and connected with housing developments, and to extend financial support to and later regulate housing finance institutions. The recent changes mentioned above are in line with these recommendations. Some of these changes are discussed below.

Commercial Banks

The role of commercial banks in housing finance had remained negligible for long. The overall policy of banks and the guidelines issued by the RBI in 1979 in this respect had tended to restrict the flow of bank funds in the housing sector. The RBI revised these guidelines in November 1988 and took many steps to increase the flow of bank credit to the housing sector, particularly for the weaker sections.

First, the yearly quantum earmarked for housing finance by the banking system is now 1.5 per cent of incremental bank deposits during the preceding 12 month, and there is no objection to banks exceeding this level upto a reasonable limit provided they have regard to their resources position and compliance with the statutory reserve requirements. Second, earlier, term loan granted by bank to housing finance companies other than HUDCO, HDFC and companies promoted/sponsored by commercial banks, were

restricted to their net-owned funds. With effect from January 1990 such companies have been made eligible for term loans from banks to the extent of three times their net-owned funds. Third, with effect from October 1989, the restriction on the quantum of housing loan per individual (of Rs.3 lakhs) has been removed, and it is left to the banks to charge a higher rate of interest over the minimum rate of 16 per cent per annum on housing loans exceeding Rs.3 lakh per individual. Moreover, now such housing loans will not form a part of banks' housing finance allocation. Fourth, effective from October 1988, margin requirements for bank's housing loans have been fixed at 20 to 35 per cent; and the repayment period has been fixed at 15 years. The banks give housing loans against mortgage of property, government guarantee, LIC policy, government promissory notes, shares and debentures. The loans are now made available for repairs, additions, acquisition and development of land. Fifth, apart from individuals, housing finance institutions, private housing finance companies, and private builders also can obtain housing loans from banks.

Housing Finance Subsidiaries

May banks and financial institutions have now set up the following special housing finance subsidiaries:

(i) Canara Bank had sponsored a housing finance company, Canfin Homes Ltd., in 1988. It has branches in about 22 Indian cities and it also operates the Home Loan Account Scheme of the (NHB). It accepts fixed and cumulative deposits which enjoy certain income-tax and wealth-tax benefits. The fixed deposits are accepted for the periods ranging from 2 to 7 years.

(ii) The GIC set up GIC Grih Vitta Ltd. (GICGVL) in July 1990 as a joint ventue with its four subsidiaries, UTI, ICICI, IFC, HDFC, and SBI Capital Markets. GICGVL has introduced various schemes to hekp people to own their homes. Under its Apana Ghar Yojana, it gives housing loans between Rs.20,000 and Rs.3.5 lakh to 5.00 lakh with repayment facility on Equated Monthly Instalment (EMI) Basis. It

has linked its activities with those of GIC Mutual Fund. For example, investors in GICRISE Unit Scheme will enjoy special benefits in terms of lower initial contribution, higher loan amount, lower EMIs, concessions in collateral security and so on in respect of its housing loans.

(iii) The LIC also set up, in 1991, a housing finance company, LIC Housing Finance Ltd. (LICHFL). It has already introduced two schemes, namely Jeevan Kutir and Jeevan Niwas. Under the former, individuals can get loans upto Rs.2 lakh depending on repayment capacity or up to 75 to 80 per cent of property value. These loans have a repayment period up to 20 years; and repayment is through monthly instalments and a small premium on Bima Sandesh Policy. Under the latter scheme, loans are given upto Rs.5 lakh, the repayment is to be made through monthly instalments or the proceeds of LIC policy over a period of 20 years.

Apart from these companies, three more housing finance companies have recently been set up, namely PNB Housing Finance Ltd. (PNBHFL), SBI Home Finance Ltd. (SBIHFL), and a State level housing finance institution of Gujarat Finance Corporation.

10.5 SUMMARY

Housing is an essential human need. The need for housing will therefore exist, as long as human beings exist in the world. It is in this contest that house financing plays a key role in providing the necessary financial assistance for construction, extension and modification of housing. Provision of basic housing facility has been one of the priorities of developing countries. International financing agencies such as the World Bank is providing all the facilities and assistance to these countries for the purpose of housing development. Many factors have contributed to the growth of housing finance in India. Budgetary support provided by the government for housing in the form of tax incentives, relatively higher pay packets for employees, new heightened competition among the HFCs, etc. are important in this regard. Housing finance companies consider such factors as the loan amount, the tenure, cost of loan etc. before deciding to extend housing finance assistance. Among the agencies that provide housing finance facility, NHB, LIC, HDFC,

HUDCO, etc. are important since they contribute more than 80 per cent of the funding required for housing development in India.

10.6 KEYWORDS

Housing Finance: A set of all financial arrangements that are made available by Housing Finance Companies (HFCs) to meet the requirements of housing development.

Housing Projects: A group of houses for apartments usually built with government money, for poor families.

Houses Estate: A large number of houses that are built together in a planned way.

10.7 SELF ASSESSMENT QUESTIONS

1. What kinds of business can be transacted by National Housing Bank?
2. Give a brief overview of various institution/agencies involved in housing finance system.
3. Discuss the recent developments that have taken place in the field of housing finance in India.

10.8 SUGGESTED READINGS

Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

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Subject	**:**	**Management of Financial Services**		

LESSON-11

CREDIT RATING

STRUCTURE

11.0 Objective
11.1 Introduction
11.2 Concept of Credit Rating
11.3 Functions of Credit Ratings
11.4 Origin of Credit Rating
11.5 Credit Rating in India
11.6 Benefits of Credit Rating
11.7 Caution to Use Credit Rating
11.8 Rating Process
11.9 Types of Rating
11.10 Credit Rating Agencies in India
11.11 Practical Problems of Credit Rating
11.12 Future of Credit Rating in India
11.13 Summary
11.14 Keywords
11.15 Self Assessment Questions
11.16 Suggested Readings

11.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Understand the concept of credit rating and its benefits.

(b) Describe the process of credit rating.

(c) Discuss the services rendered by the credit rating agencies in India.

(d) Explain the problems of credit rating and future of credit rating in India.

11.1 INTRODUCTION

The changing financial scenario in our country after liberalization movement has led to emergence of many new institutions which were concomitant for changed financial set up. In this scene there have been innovations in the financial instruments, a result of financial engineering. Irrespective of type of financial instrument the basic parameter to evaluate an investment proposal have been the return and safety. Debt instruments have been playing an important role for raising funds and in times to come still it is most potential avenue. The basic feature of debt i.e. assured return is very attractive for investors to plan their portfolio but it is associated with a risk especially if it is unsecured. How the investors is to gauge such risks? Credit Rating is the answer.

Credit Rating is a symbolic indicator of the current objective assessment by a rating agency of the relative capability and willingness of an issuer of a debt programmes to service the debt obligations as per the terms of the contract. It may be referred as current opinion of a borrower's credit quality in terms of business and financial risk. On the basis of such evaluation the investors get some idea about the degree of certainty of timely repayment of the principal amount of the debt instrument besides regular payment of returns on it i.e. interest. So credit rating is neither a general purpose evaluation of a corporate entity nor an overall assessment of the credit risk associated with the instruments issued or to be issued by the concerned business house. It only indicates a representatives characters of the particular security which does not amount to any recommendation to purchase, sell or hold that security.

11.2 CONCEPT OF CREDIT RATING

To understand the concept of credit rating it is worth to have an idea of different credit rating agencies what they consider credit rating as:

Investment Information and Credit Rating Agency of India Ltd. (ICRA)

Rating is a symbolic indicator of the current opinion of the relative capability of timely servicing of debt and obligations by the corporate entity with reference to the instrument rated.

Credit Rating Information Services of India Ltd. (CRISIL)

Rating is current opinion as to the relative safety of timely payment of interest and principal on a debenture, structured obligation, preference shares, fixed deposits programme or shot term instruments.

Credit Analysis and Research Ltd. (CARE)

Credit rating is an opinion on the relative ability and willingness of an issuer to make timely payment on specific debt or related obligations over the life of the instrument.

Australian Ratings

Rating provides lender with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted.

Standard & Poors

Rating is current assessment of the credit worthiness of an obligor with respect to specific obligation.

From the above definitions it is understood that:

(i) Credit rating is an assessment of the capacity of an issuer of debt security, by an independent agency, to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument

through out the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.

(ii) The ratings are expressed in code number which can be easily comprehended even by the lay investors. The ratings are the quickest way of understanding a company' financial standing without going into the complicated financial reports. Credit rating is only a guidance to the investors and not a recommendation to a particular debt instrument. The important element for investment decision making in debt security are (i) yield to maturity (ii) risk tolerance to investor and (iii) credit risk of the security. Clearly the focus of credit rating is on any one of these three elements viz., credit risk of the security and hence it can not by itself be a basis for investment decision making. It is only a current opinion on the relative capacity of firms to repay debt in time.

(iii) Credit rating, as it exists in India, is done for a specific debt security and not for a company as a whole. No rating agency tells that it is an indicator of the financial status of the company. All that a rating agency claims is that the rating symbols indicate the capacity of the company to honour the terms of contract of a debt instrument.

(iv) A debt rating is not a one time evaluation of credit risk, which can be regarded as valid for the entire life of the security. It is an on going appraisal. Changes in dynamic world of business may imply a change in the risk characteristics of the security. Hence debt rating agencies monitor the business and financial conditions of the issuer to determine whether modification in rating is warranted.

(v) A credit rating does not create a fiduciary relationship between the rating agency and the users of rating since there is no legal basis for such relationships.

11.3 FUNCTIONS OF CREDIT RATINGS

The credit rating firms are supposed to do the following functions :

1. Superior Information

Rating by an independent and professional firm offers a superior and more reliable source of information on credit risk for three inter related risks:

(a) It provides unbiased opinion.

(b) Due to professional resources, a rating firm has greater ability to assess risks.

(c) It has access to lot of information which may not be publicly available.

2. Low Cost Information

A rating firm which gathers, analyses, interprets and summarizes complex information in a simple and readily understood format for wide public consumption represents a cost effective arrangement.

3. Basis for a Proper Risk-Return Trade Off

If debt securities are rated professionally and if such ratings enjoy widespread investor acceptance and confidence, a more rational risk return trade off would be established in the capital market.

4. Healthy Discipline on Corporate Borrowers

Public exposure has healthy influence over the management of issuer because of its desire to have a clear image.

5. Formulation of Public Policy Guidelines on Institutional Investment

The public policy on the kinds of securities that are eligible for inclusion in different kinds of institutional portfolios can be developed with great confidence if securities are rated professionally by independent agencies.

11.4 ORIGIN OF CREDIT RATING

The credit rating concept originated in the USA. In 1860, Henry Vannum started publishing financial statistics of railroad companies in 1909, Mood's Investors Agencies started rating Railroad giving more thrust to the concept. Since then the importance has grown extensively in the global market. System of ratings got institutionalized following the Great Depression. In 1933, the US Controller of Currency enacted a rule that banks could purchase securities rated only BBB/Baa or above. In 1970, Penn Central, then largest Railroad company in the world went bankrupt with just under $100 million in outstanding commercial paper. This forced the investors to ask for rating for commercial paper volume and 99% of the corporate bond volume are rated in the U.S.A.

11.5 CREDIT RATING IN INDIA

The environment that prevailed in America when first ratings were assigned, prevails in many developing countries today. The Indian capital market has witnessed a tremendous growth in the past few years. Companies are relying on capital markets for financing existing operations as well as for new projects rather than on institutions. In this process, the average size of debenture issued by companies, the number of companies issuing debentures and the number of investors have grow substantially.

As the number of companies borrowings directly from capital market increases, investors find that the company's size or name is no longer a sufficient assurance of the timely payment of interest and principal. Default by large and well known companies recently in payment of interest on fixed deposits or debentures has reinforced this belief among investors. They felt the need for an independent and credible agency which judges the quality of debt obligations of different companies' and assists individual and institutional investors in making investment decisions.

In this context, the Credit Rating Information Services of India Limited was set up in 1987. Following this, Investment Information and Credit Rating Agency of India was

promoted in 1991 and Credit Analysis and Research Limited was floated in 1993. All the three credit rating agencies have been approved by the Reserve Bank of India.

11.6 BENEFITS OF CREDIT RATING

The following are the benefits of credit rating :

1. Low Cost Information

Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information is done by a specialised agency which a group of investors can trust.

2. Quick Investment Decision

In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

3. Sources of Additional Certification

Credit rating agency provides additional certification to the issue of debt/financial instrument. A highly rated firm can enter the market with great confidence. Indian experience shows that individual companies that use credit rating, benefit a great deal by getting larger amount of money from a wider audience at a lower cost.

4. Increase the Investors Population

A sound credit rating system gives an alternative method to name recognition as a determining factor in making investment and helps increase the population of those investing in debt obligations of the company.

5. Forewarns Risks

Credit rating acts as a guide to companies which get a lower rating. It forewarns the management of the perception of risk in the market and prompts to take steps

on their operating and marketing risks and thereby changes the perception in the market.

6. Encourages Financial Discipline

Rating also encourage discipline among corporate borrowers to improve their financial structure and performance to obtain better rating for their debt obligations.

7. Merchant Bankers Job Made Easy

Merchant bankers and brokers will be relieved of the responsibility of guiding investors as to the risk of a particular investment. Merchant bankers and brokers, in the absence of objective information, go on the basis of name recognition in guiding their clients. With the advent of credit rating, what they would be required to do is to bring to the attention of their clients the ratings of debt obligations.

8. Investors Protection

Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. A credible and objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

9. Foreign Collaborations made Easy

The foreign collaborators always ask for credit rating while negotiating with an Indian company. Credit rating enables to identify instantly the relative credit standing of the company. The importance of credit rating is being increasingly recognized in the Euro-markets.

10. Benefits the Industry as a Whole

Relatively small and unknown companies use ratings to instill confidence in investors. Higher rate companies get larger amount of money at a lower cost. Thus the industry as a whole can benefit from ratings by direct mobilization of savings from individuals rather than from intermediary lending institutions.

11.7 CAUTION TO USE CREDIT RATING

There is negative side of credit rating also. The users should use credit rating keeping in view its constraints or limitations. The rating done for an instrument should not be taken as rating of the image of the company. Further, it should be appreciated that in rating there is scope for bias observation. It is not a perfect exercise. Rating, despite the provision of surveillance, cannot be updated on account of every substantial change in the influencing factors. This is why credit rating is said to be a static exercise. In case the client company conceals material information from rating agency, then reliability of credit rating will be doubtful.

11.8 RATING PROCESS

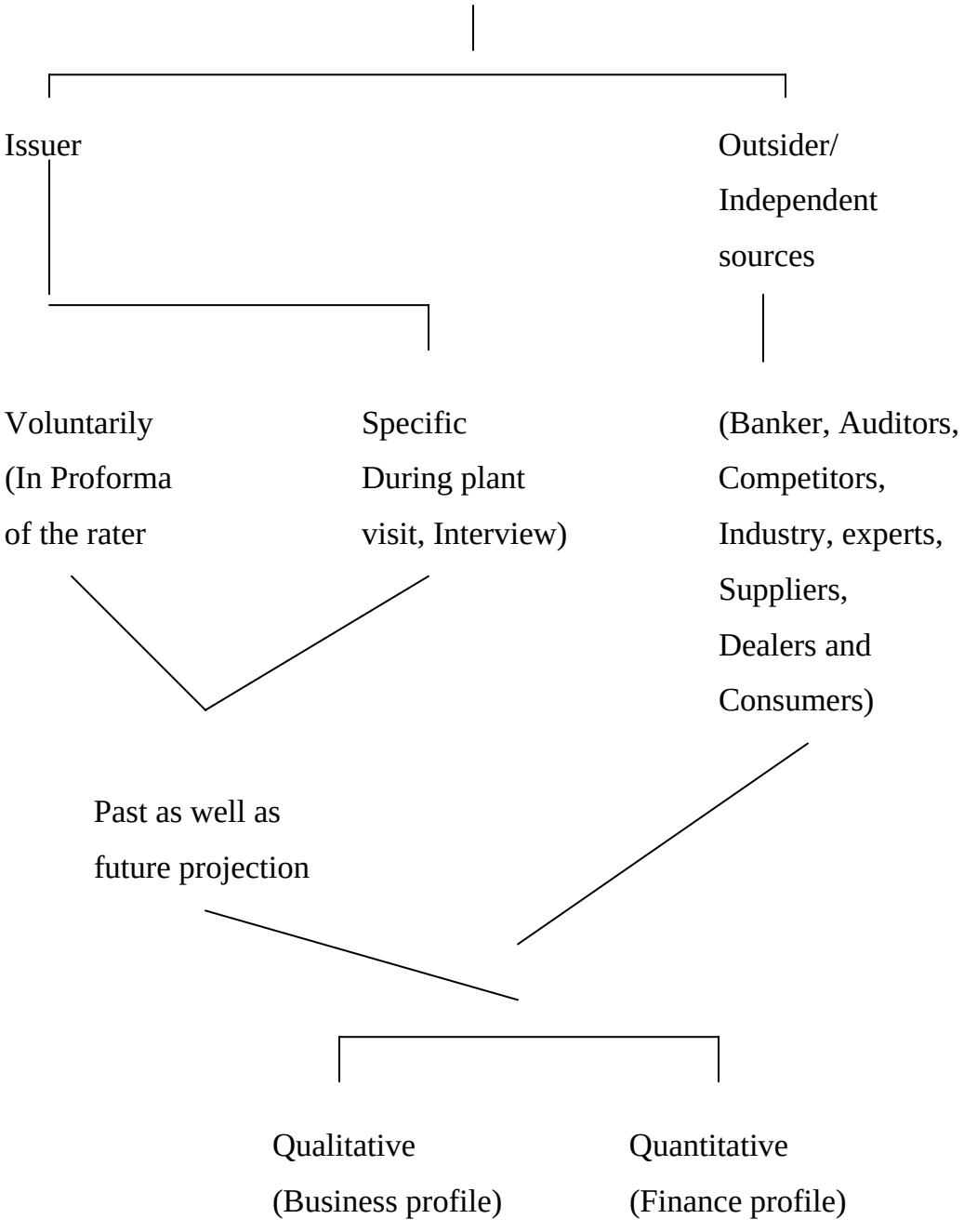
Any rating agency assigns a rating only when there is adequate information available to form a credible opinion and only after extensive quantitative, qualitative and if appropriate legal analyses are performed. The process of rating is broadly three tier system :

(a) Information

When the issuer approaches the credit rating agency, it is to provide relevant information to them. The information required by the rating agency is such which gives the real picture of the issuer. The nature and source of information required is presented in Chart I. The credit rating agency besides depending on the information provided by the issuer collects additional information from its own sources. The information required about the issuer is not only of the past but also about its feature prospects.

Chart I

Source of Information


Issuer
Outsider/ Independent sources
Voluntarily (In Proforma of the rater
Specific During plant visit, Interview)
(Banker, Auditors, Competitors, Industry, experts, Suppliers, Dealers and Consumers)
Past as well as future projection
Qualitative (Business profile)
Quantitative (Finance profile)

(b) Analysis of Information

The rating process of rating agencies is almost similar since the basic parameters to be observed to assess risks associated are same. Rating is a search for long term fundamentals and the probabilities for changes in the fundamentals. Rating fundamentals analyse not only financial profile of the concerned issuer in context of the instrument to be rated but also evaluate its business or competitive strengths or weaknesses. These fundamentals are discussed below one by one before taking up rating process :

A. Financial Profile

Financial profile for which an in-depth study is made for issuer, covers liquidity position, capital structure, financial flexibility, cash flow adequacy, profitability, leverage, interest coverage etc. The historical facts and future projections both are extensively used for these parameters. Besides considering these, the rating agency also critically evaluates accounting policies and practices with particular reference to practices of providing for depreciation, income recognition, stock valuation, valuation of fixed assets, off balance sheet claims and liabilities etc. Extensive use is made of ratio analysis techniques. The major ratios computed are :

i) Coverage ratio : The main determinant of the quality rating of debt obligation is its coverage ratio. Coverage ratio is a measure of how many times the issuing company earned income could pay the interest changes and other cost related to the debt issue. This ratio hints at probability of default in interest payment. The trend analysis of this ratio is also of immense use. An upward trend indicates better time ahead.

ii) Financial leverage ratios : It is a set of ratios used to assess broadly what is the mix of fund sources. A leverage is added if a dose of debt fund is used in total funds. Higher the proportion of owned funds, lesser is the leverage and consequently more solvent the company is. A highly leveraged company’s debt instruments are ranked more risky. Prime ratio used here is debt-equity ratio.

Another ratios used can be long term debt to total capitalization (long term debts + short term debts + net worth) and long term debts to equity. Rating analysts are also to consider all off balance sheet liabilities and commitments of the company to have actual idea about solvency.

iii) **Liquidity ratios :** To know the firms ability to pay debts currently coming due, liquidity ratios are calculated. Most common ratios in this category, also known as short term solvency ratios, are current ratio and quick ratio. Besides these ratios some analysts also compute and consider ratios like inventory turnover ratio, receivable turnover ratio and collection period in days. This set of ratios reflect the efficient or otherwise use of liquid resources by the issuer.

iv) **Cash flow ratios :** If cash flow of a company is sufficient in relation to interest payment liability and total long term debts, the debt instrument of the company may get higher rating. Cash flow is normal operating income before interest, tax and deprecation. If cash flow to total long term debt ratio is less than the firms' interest rate on debts, there is a possibility that firm may default in making payments.

v) **Profitability ratios :** Another significant set of ratios is profitability ratios which indicate profit earning capacity of a company. Earnings are viewed in relation to burden of fixed changes. This set of ratios indicate the real financial health of the company. A company with higher ratios will certainly be better off in times to come. The ratios to be calculated are operating profit ratio, net profit ratio and return on investment ratio. The trend of these ratios can assist projection of financial health in future which is very relevant for rating of debt instruments.

B. Business Profile

The rating process, as mentioned earlier, is not limited to the evaluation of financial profile. Quality of debt instruments is influenced by many other variables which are not covered in examination of financial profile. Say in a rating agency financial

evaluation of M/s ABC is presented which is very sound on profitability as well as liquidity front. The agency proposes to give it highest safety symbol. But say one of the analyst says that despite all these facts I don't agree to award highest safety symbol. He reveals that the product in which M/s ABC is dealing a better one and cheaper product has been recently patented. M/s ABC will no longer have the same segment of market as it use to have earlier. It is a very logical point which needs to be considered since it will influence over all earning of the firm. There can be so many other factors which are not considered in financial analysis. All such factors for convenience are grouped under the head business profile. The main factors considered here are discussed one by one.

i) Issuer's industry : The nature of industry to which issues belong has an impact on rating of the instrument. The following questions need to be answered:

a) Is the company in a capital goods industry, consumer durable goods industry, or consumer non-durable goods industry?

b) Is the industry in a growth, stable or declining phase?

c) What is the nature and intensity of the competition in the industry? Is it on a regional, national or international basis? Is it based on price, quality of product, marketing strategy?

d) What is the labour situation in the industry? Is the industry unionized? If so are the labour contracts negotiated on industry level?

e) What is the status and history of supply factor of key raw material?

f) How fast have been the technological upgradation? What have been the recent developments and possibility of future developments not only in the country but abroad also?

g) Is the industry subject to some controls like in case of price control in cement, sugar, steel etc.?

h) Is the company participating in more than one business? What are the potentials of all important business lines?

Answer to these questions enables the analyst to cause the industry risk which can be introduced in his model of rating. The industries with steady demand, growth and ability to maintain margins without impairing future prospect are regarded favorably while rating obviously a change in outlook for industry will lead to change in the rating for the companies in that industry.

ii) Issuer's competitors : After general evaluation of industry, specific evaluation of issuer's position in the industry needs be studied. The main question for it are:

a) Does the company have a large enough portion of the market share to influence industry dynamics significantly?

b) Does the company has a full range of products or have proprietary products or a special rich in the market?

c) Is the company a relatively low cost producer?

d) Are the technical facilities with the company newer or more advanced than the average competitors?

e) Does the company face more onerous labour situation than its competitors?

f) Does the company has competitive advance through marketing and distribution strength?

g) What is the financial strength of the company in context of the competitors?

The response to above mentioned questions give a valuable clue to put a company in most suitable category of risk ranking.

iii) Issuer's management : Operating efficiency to a large extent is dependent on the management of the issuer company. It is the management's track record which also influences determining risk tolerance. Management is tested on the related points important of which are as under :

a) What is the background and history of issuer?

b) What is the extent of reliance on Chief Executive Officer specially who may be close to retirement?

c) To what extent is the management professional?

d) How effective is the control mechanism in the company?

e) What is the report of past and present creditors of the company?

f) What is the relationship between organizational structure and management strategy?

g) How is management able to maintain strategies and policies or retain credit worthiness in the times of stress?

h) How competent is the management to cope with short term charges?

iv) Issuer's Instrument : Debt instrument to be rated spells out certain rights of the owners. The various protective provisions contained in the terms and conditions/prospectus of debt instrument also raises the quality rating for the instrument. Such protections can be creating security against the instrument to make it secured fully or partly. The issuer can subordinates other legal claims on its assets or income. The issuer may create redemption reserve or sinking fund to pay off bonds even if the issuer defaults on its other debts. Trustees may be appointed to protect the interest of investors. Many of such provision are obligatory in Indian context.

These are the main indicative parameters examined by every rating agency. Thus, methodology used is almost similar. Almost similar information is sought by all agencies for rating purposes. The rating methodology thus involves coverage of a vide spectrum of the company's activities and is extremely exhaustive. An issuer, therefore, is scrutinized thoroughly on all the areas mentioned.

(c) Granting Rating Symbol : The process starts with the request of the prospective issuer's formal request for rating. The issuer is generally asked to submit required information in a set proforma of essential items. This is not an exhaustive list.

The issuer should feel free to provide additional information on any relevant aspect. The issuer company is also to provide its financial profile for last 4-5 years along with audit reports. The rating agency assigns an analytical team for the issue. The analyst

take up the assignment of additional data, which they consider to be relevant. They give chance to issuer to make his presentation. The questions are raised and answers are sought.

The team may visit the premises to gather first hand information especially about qualitative aspects. They may have assess to books of record. They can interact with the executives and other concerned officials. To review in detail the borrower's key operating and financial plans, management policies and credit factors can also be analysed. The data base of the rating agency about industry concerned is also extensively used.

Following this review and discussion, a recommendations is made by the primary analyst and a rating committee meeting is convened. The committee discusses the recommendations and the pertinent facts supporting the rating. Finally the committee votes on the recommendations.

The borrower is subsequently notified of the rating and the major supporting considerations. A borrow can appeal against a rating decision prior to its publication. If new or meaningful additional information is presented by the borrower, it will be considered by the rating committee. However, rating agencies may not guarantee that this new information will alter the rating committee's decision.

Once a final rating is assigned, it will disseminated to agency's subscriber clientele and publicly through the news media if the issuer accepts the rating. If rating is not acceptable, agency may not make public that rating. Rating agency otherwise also ensures strict confidentiality of all information collected during the rating process. Once the rated company decides to use the rating, the agency monitors the rating till the redemption/repayment of the debt obligation.

At regular intervals company is supposed to submit the updated data and communicate major changes in policy matters, if any. This surveillance system continues till the life of the concerned instrument. Under this system a formal review is conducted

annually; new developments, industry trends and financial performance releases are reviewed regularly. As a result rating may be changed or withdrawn. Rating agencies have right to disclose such changes in rating to public.

While this general framework applies to all rating exercises, there are some areas where additional specific information is needed to make the rating decisions for a specific instrument.

11.9 TYPES OF RATING

The rating methodology and process discussed earlier is primarily for debt instruments like debentures, fixed deposits, bonds etc. This type of rating constitutes the major business of a rating company. But with the passage of time these agencies have started providing other types of rating such as :

a) Equity rating

Rating of equity shares issued in capital market is termed as equity rating. In such exercises the opinion on the earnings prospects and risk associated with such earnings can be arrived at through comprehensive information on acquisition, interaction with the management of the corporate, critical analysis and collective judgmental process. This exercise is also known as ‘equity grading’ which is initiated on the initiative of the issuer of equity before making a public issue. Grading examines very closely the level, quality, growth and substantiality of earnings in the medium term on the expanded equity base resulting from the present offer and other known future equity expansion. Like credit rating, equity grading can also be communicated both as a symbolic grade and a detailed rational. Surveillance such grading will make it relevant for secondary market of the issued share. The key parameter in the whole exercise is the prospective return on net worth. Rating agencies may also make equity assessment at the request of institutional investors with the consent of the corporate house whose equity is sought to be assessed.

b) Mutual fund rating

Mutual Funds which are popular world over are evaluated by rating agencies and it is known as mutual fund rating. It facilitate selection of right fund from the available funds. Given the nature of mutual funds, the analysis of performance has to rely to a large extent, on past performance. Therefore, evaluation is primarily based on the two indicators 'risk and return'. Expense ratio, turnover ratio, composition of portfolio, accounting practices, fund management qualities, NAV in past are some of the main parameters to evaluate mutual funds.

c) Individual credit rating

Consumer finance is gaining popularity in developing countries. The success of consumer finance depends on the credit worthiness of the consumer. Rating agencies may take up rating of such individuals. Individual credit rating is own objective assessment of the risk attached to a financial transaction with respect to an individual at a given point of time based on qualification of parameters influencing credit risk. Every aspect of credit seeker's history; age, qualification, occupation, stability at work, residence, martial status, assets, repaying capacity, savings and earnings potentials are used to assess creditworthiness of an individual. Agencies broadly rate individuals on social status, economic status and financial status.

d) Rating of banks and financial companies

Banks and financing companies are also issuers of debts like banks issue certificates of deposits (CD). The issuer's internal affair is scanned by evaluation of their background and history. Their relation with government and central bank are studied. The issuer's innovations and competitive ability to attract cheaper funds is analysed. Maturity pattern between the source and deployment of fund is studied. Its competitive position and market share is also studied. The rating exercise could include a case by case review of major non-performing assets to determine the prospect of reliability. The quality of assets is judged. Profitability is also gazed. The quality of management is judged by the

profile of operating executives, human resources policies and organizational structure. In case of financial companies, support of group companies could be important in determining their success. Accounting figures are considered after adjusting for non standard accounting policies.

e) Sovereign rating

It is primarily rating of a country as to its credit worthiness and probability to risk etc. In this process economic parameters and economic policies of the country are under constant observation. Such rating influences the availability of foreign aids from agencies like World Bank. All rating agencies may not take up such assignment because of lack of infrastructure and specialists.

f) Rating structured obligation

Structured obligation is a negotiable instrument or security which is backed by some asset. The main role of a credit rating agency in analyzing an asset backed security or a structured obligation is to assess the risk of default in meeting the contractual obligations to the investors. As in the rating of conventional debt instruments, the rating assesses the default risk rating to other debt instruments available to the investor. The main thrust in the evaluation of an asset backed transaction is to ensure that the cash flows from the assets and the envisaged structure are capable of meeting the committed payments to the investors even in a “worstcase” scenario. A key point to kept in mind is that in the rating of a structured obligation it is not rating the issuer but is assessing the risk associated with the transaction. More specially, a AAA rating on a particular structured obligation of a particular originator does not necessarily mean that all other issues by the entity would also get a AAA.

11.10 CREDIT RATING AGENCIES IN INDIA

Currently there are four credit rating agencies in India.

1. Credit Rating Information Service Ltd. (CRISIL)

2. Information and Credit Rating Agency of India (ICRA)
3. Credit Analysis and Research (CARE)
4. Duff Phelps Credit Rating Pvt. Ltd. (DCR India)

1. Credit Rating Information Service Ltd. (CRISIL)

On January 1, 1988 the Industrial Credit and Investment Corporation of India (ICICI) and Unit Trust of India (UTI) joined hands to float CRISIL, first rating agency in India with an equity base of Rs.4.00 crores. Each of them holds 18 per cent of the stock. The other promoters are : The Asian Development Bank (15 percent) ; the LIC, the GIC and its subsidiaries and the State Bank of India (each 5 per cent); the Housing Development Finance Corporation (6.2 per cent); 9 nationalized Banks owning 19.5 per cent, the remaining equity is distributed among 10 foreign banks i.e. Standard Chartered Bank, Banque Indo Suez, Mitsui Bank, Bank of Tokyo, Hongkong and Shanghai Banking Corporation, Citi Bank, Grindlays Bank, Deutsche Bank, Societe General, Banque Nationals de Peris. CRISIL became a public limited company in November 1993 and is presently a quoted company on the Bombay Stock Exchange.

Objective : The main objective of CRISIL has been to rate debt obligation of Indian companies. Its rating provides a guide to the investors as to the risk of timely payment of interest and principal on a particular debt instrument. Its ratings create awareness of the concept of credit rating amongst corporations, merchant bankers brokers, regulatory authorities and helps in creating environment that facilitates the debt rating.

At the time when CRISIL commenced its operations it was contemplated that it would undertake credit rating for a company at its specific request and subsequently it might cover all companies on its own initiative with the basic idea to provide information about creditworthiness of all companies whether they approach CRISIL or not so that investors know about the company offering securities to the public. It had also envisaged to cover under credit rating all securities viz. equity shares as well as preference shares, debentures, secured, unsecured convertible and non-convertible and fixed deposits. To

achieve the objectives and contribute towards stable and healthy growth of the Indian Capital market, the thrust of the CRISIL operations was planned towards :

i) Shifting the primary responsibility of established corporate credit quality from the merchant bankers/brokers/underwriters/financial advisor to CRISIL and making available widely acceptable standard and uniform rating for the investors;

ii) Providing for increased disclosure, better accounting standards improved financial information to the users i.e. individual investors, financial institutions, stock exchange and corporate research bodies;

iii) Reducing the cost of issue by helping direct mobilization of finance without depending on intermediary agencies; and

iv) Protecting the interest of investors by constant monitoring of the results of rated companies and altering the grading to reflect the true and fair state of affairs of the financial position of companies.

Credit Rating Symbols : CRISIL uses the conventional rating symbols used in the USA and widely accepted in many other countries. The following table shows the investment wise rating symbols assigned by CRISIL and the meaning of each rating from the angle of safety to the investors.

CRISIL Debenture Rating Symbols

High Investment Grades		
AAA (Triple A)	:	Highest Safety
AA (Double A)	:	High Safety
Investment Grades		
A	:	Adequate Safety
BBB (Triple B)	:	Moderate Safety
Speculative Grades		
BB (Double B)	:	Inadequate Safety
B	:	High Risk
C	:	Substantial Risk
D	:	Default

Notes : (1) CRISIL may apply '+' (plus) or '-' (minus) sign for ratings from AA to C to reflect comparative standing within the category.

(2) The contents within parenthesis are a guide to the pronunciation of the rating symbols.

(3) Preference shares rating symbols are identical to debenture rating symbols except that the letters 'pf' are prefixed to the rating symbols, e.g. pf AAA ("pf Triple A").

CRISIL Fixed Deposit Rating Symbols

Investment Grades		
FAAA (F-Triple A)	:	Highest Safety
FAA (F-Double A)	:	High Safety
FA	:	Adequate Safety
Speculative Grades		
FB	:	Inadequate Safety
FB	:	High Risk
FC	:	Substantial Risk
FD	:	Default

Notes : (1) CRISIL may apply '+' (plus) or '-' (minus) sign for ratings from FAAA to FC to indicate the relative position within the category.

(2) The contents within parenthesis are a guide to the pronunciation of the rating symbols.

Credit Rating for Short Term Instruments

Rating Symbol	Indication (Each rating indicates that the degree of safety regarding timely payment on the instrument is shown against the symbol)
P-1	Very Strong
P-2	Strong
P-3	Adequate
P-4	Minimal
P-5	Expected to be in default on maturity or in default

Note : CRISIL may apply "+" signs for ratings from P-1 to P-3 to reflect a comparatively higher standing within the category.

CRISIL monitors the ratings it assigns constantly. The ratings may be upgraded, downgraded or withdrawn depending upon new information or developments concerning the company whose debt obligation is rated. It has the right to widely disseminate the ratings through the media, through its own publications or through any other methods.

2. ICRA Ltd

The ICRA Ltd. has been promoted by the IFCI Ltd. as the main promoter to meet the requirements of the companies based in the northern parts of the country. Apart from the main promoter, which holds 26 per cent of the share capital, the other shareholders are the Unit Trust of India, banks, LIC, GIC, Exim Bank, HDFC Ltd. and ILFS Ltd. It started operations in 1991. In order to bring international experience and practices to the Indian capital markets, the ICRA has entered into a MOU with Moody's Investors Service to provide, through its company Financial Programmes Inc (FPI), credit education, risk management software, credit research and consulting services to banks, financial/investment institutions, financial services companies and mutual funds in India. As in the case of the CRISIL, the main objectives of the ICRA are :

- To assist investors, both individual and institutional, in making well informed decisions;
- To assist issuers in raising funds, from a wider investor base, in large amounts and at a lower cost for highly rated entities;
- To enable banks, investment bankers, brokers in placing debt with investors by providing them with a marketing tool and
- To provide regulators with market driven systems to encourage the healthy growth of the capital markets in a disciplined manner, without additional burden on the Government.

Over the years, the ICRA has diversified the range of its services. It currently provides three types of services ; (1) rating services; (2) information services and (3) advisory services.

ICRA Rating Scale

Long Term including Debentures Bonds and Preference Shares

LAAA	:	Highest Safety
LAA	:	High Safety
LA	:	Adequate Safety
LBBB	:	Moderate Safety
LBB	:	Inadequate Safety
LB	:	Risk Prone
LC	:	Substantial Risk
LD	:	Default, Extremely Speculative

Medium Term including Deposits Fixed

MAAA	:	Highest Safety
MAA	:	High Safety
MA	:	Adequate Safety
MB	:	Inadequate Safety
MC	:	Risk Prone
MD	:	Default

Short Term Including Commercial Paper

A-1	Highest Safety
A-2	High Safety
A-3	Adequate Safety
A-4	Risk Prone
A-5	Default

Note : (i) The rating symbols group together similar (but not necessarily identical) concerns in terms of their relative capability of timely servicing of a debts/obligations, as per terms of contracts, i.e., the relative degree of safety/risk.

(ii) The sign (+) or (-) may be used after the rating symbol to indicate the comparative position of the company within the group covered by the symbol.

(iii) The letter ‘P’ in parenthesis after the rating symbol indicates that the debt instrument is being used to raise resources by a new company for financing a new project and the rating assumes successful completion of the project.

(iv) The rating symbols for different instruments of the same company need not necessarily by the same.

3. CARE Ltd.

The CARE Ltd. is a credit rating and information services company promoted by the Industrial Development Bank of India (IDBI) jointly with financial institutions, public/private sector banks and private finance companies. It commenced its credit rating operations in October 1993 and offers a wide range of products and services in the field of credit information and equity research. Unlike the CRISIL and the ICRA, the CARE is very cautions in entering new areas of business. Currently, it offers the following services:

(a) Credit Rating : The CARE undertake credit rating of all types of debt instruments, both short-term and long-term.

(b) Advisory Services : The CARE provides advisory services in the areas of :

- Securitisation transactions;
- Structuring financial instruments;
- Financing of infrastructure projects and
- Municipal finances

11.11 PRACTICAL PROBLEMS OF CREDIT RATING

1. The absence of widespread branch net work of the rating agency may limit its skills in rating.
2. Inexperienced, unskilled or overloaded staff may not do justice to their job and the resulting ratings may not be perfect.
3. Since rating exercise involves a number of factors, a rigid mathematical formula can not be applied to finalize rating and some element of subjectivity creeps in, thereby giving scope for bias.
4. The time factor greatly affects rating and gives misleading conclusions. A company which experiences adverse conditions temporarily will be given a low rating judged on the basis of temporary phenomenon.

5. Since the rating agencies receive a sizable fee from the companies for awarding ratings, a tendency to inflate the ratings may develop.
6. The rating is not permanent but subject to changes and moreover the agencies can not give any guarantee for the investors.
7. Investment which have the same rating may not have identical investment quality because the number of rating categories is limited and hence can not reflect small but meaningful differences in the degree of risk.
8. Borrowing entities give misleading advertisements about the rating symbols of their instruments. For example, 'X' Co. Ltd. which has got AAX for its debenture may mobilize fixed deposits instead of revealing the low rating for fixed deposits. Such kind of window dressing should be curtailed.

11.12 FUTURE OF CREDIT RATING IN INDIA

At present, commercial paper, bonds and debentures with maturities exceeding 18 months and fixed deposits of large non-banking companies registered with RBI are required to be compulsorily rated. There are moves to make rating compulsory for other types of borrowings such as the fixed deposit programme of manufacturing companies. In addition, the rating agencies and expected to be called upon to enlarge volumes of securitisation of debt and structuring of customized instruments to meet the needs of issuers or different class of investors. There are number of areas where rating agencies will have to cover new ground in the coming years. The rating of municipal bonds, state government borrowings, commercial banks and public sector undertakings etc. will be covered in the near future. So, the outlook for the credit rating industry is positive. The industry has to continuously strive to improve professional capabilities and sustain its credibility.

11.13 SUMMARY

Financial intermediaries play an important role in linking savers and investors, and thus assisting in the mobilization of capital on the one hand, and efficiently allocating them between competing users on the other. This calls for the use of reliable market information. An investor in search of investment avenues has recourse to various sources of information, such as offer documents of the issuer(s), research reports of market intermediaries, media reports etc. In addition, they can also base their investment decisions on the grading offered by credit rating agencies. Credit rating is a process of assigning a symbol that acts as an indicator of the current opinion regarding the relative capability of the issuer to service debt obligations in a timely fashion, with specific reference to the instrument being rated. Credit rating is advantageous to investors, issuers, intermediaries and to regulators alike. Many factors have contributed to the growth of the credit rating system in the world. The international credit rating agencies are Moody's Investor Services, S & P, Duff and Phelps Credit Rating company, etc. Some of the domestic rating agencies include CRISIL, CARE, ICRA, etc. The rating framework considers both business and financial factors while assessing credit worthiness and assigning grades. In addition to bond rating, agencies also provide grades for equity instruments. Inspite of all the benefits of rating one must remember the fact that rating is merely for guidance and is not a recommendation to buy or sell or retain an instrument.

11.14 KEYWORDS

Credit Rating: Process of a symbolic indication of the current opinion of the relative capability of the issuer to service its debt obligation in a timely fashion.

CARE: Credit Analysis and Research, a credit rating agency that offers rating grades on debt instruments besides providing sector-specific industry reports.

ICRA: Investment Information and Credit Rating Agency of India Limited that offers rating, advisory and investment information service.

Equity Rating: Rating of equity issues aimed at contributing towards the enhancement of capital mobilization process.

11.15 SELF ASSESSMENT QUESTIONS

1. What is meant by credit rating? Discuss the functions of credit rating firms.
2. Discuss the rating process followed by credit rating firms.
3. State the benefits of credit rating.
4. Explain the working of various credit rating agencies in India.

11.16 SUGGESTED READINGS

Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

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LESSON-12

CREDIT CARD

STRUCTURE

12.0 Objective
12.1 Introduction
12.2 Concept of a Credit Card
12.3 Types of Credit Card
12.4 Parties to a Credit Card
12.5 Procedure at the time of purchase at member establishments
12.6 Benefits of Credit Cards
12.7 Demerits of' credit cards
12.8 Credit card business in India
12.9 Future Prospectus
12.10 Summary
12.11 Keywords
12.12 Self Assessment Questions
12.13 Suggested Readings

12.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Understand the concept of credit card and various types of credit cards.

(b) Identify the various parties of credit cards.

(c) Explain the benefits and demerits of credit cards.

(d) Critically examine the status of credit cards in India.

12.1 INTRODUCTION

Credit cards are innovative ones in the line of financial services offered by commercial banks. The idea of credit card was first developed by a Bavarian Farmer, Franz Nesbitum Mc Namara, an American businessman who found himself without cash at a weekend resort founded Diner's card in 1950. Right from that time, the commercial banks and non-banking companies in USA adopted the idea of credit card to develop their business. Barclays Bank was the first bank to introduce credit card in 1966 in Britain. The credit card business got momentum in sixties and a number of banks entered the field in a big way.

Credit card culture is a old hat in western countries. In India, it is relatively a new concept that is fast catching on. The present trend indicates that the coming years will witness a burgeoning growth of credit cards which will lead to a cashless society.

12.2 CONCEPT OF A CREDIT CARD

A credit card is a card or mechanism which enables cardholders to purchase goods, travel and dine in a hotel without making immediate payments. The holders can use the cards to get credit from banks upto 45 days. The credit card relieves the consumers from the botheration of carrying cash and ensures safety. It is a convenience of extended credit without formality. Thus credit card is a passport to, "safety, convenience, prestige and credit".

12.3 TYPES OF CREDIT CARD

According to the purpose for which the credit cards are used, they can be classified into three main categories:

1. Credit Card

It is a normal card whereby a holder is able to purchase without having to pay cash immediately. This credit card is built around revolving credit principle. Generally a limit is set to the amount of money a cardholder can spend a month using the

card. At the end of every month, the holder has to pay a percentage of outstanding. Interest is charged for the outstanding amount which varies from 30 to 36 per cent per annum. An average consumer prefers this type of card for his personal purchase as he is able to defer payment over several months.

2 Charge Card

A charge card is intended to serve as a convenient means of payment for goods purchased at member establishments rather than a credit facility. Instead of paying cash or cheque every time the credit card holder makes a purchase, this facility gives a consolidated bill for a specified period, usually one month. Bills are payable in full on presentation. There are no interest charges and no preset spending limits. The charge card is useful during business trips and for entertainment expenses, which are usually borne by the company. Andhra Bank card, BOB cards, Can card, Diner's Club card etc. belong to this category.

3. In-Store Card

The in-store cards are issued by retailers or companies. These cards have currency only at the issuer's outlets for purchasing products of the issuer company. Payment can be on monthly or extended credit basis. For extended credit facility interest is charged. In India, such cards are normally issued by Five Star Hotels, resorts and big hotels.

New Types of Credit Cards

1. Corporate Credit Cards

Corporate cards are issued to private and public limited companies and public sector units. Depending upon the requirements of each company, operative Add-on cards will be issued to persons authorised by the company i.e., directors, secretary of the company. The name of the company will be embossed on Add-on cards along with the name of the Add-on cardholder. The main card is only a dummy card number in the name of the company for the purpose of billing all the

charges. The transactions made by Add-on cardholders are billed to the main card and debits are made to the Company's Account.

2. Business Cards

A business card is similar to a corporate card. It is meant for the use of proprietary concerns, firms, firms of Chartered Accountants etc. This card helps to avail of certain facilities for reimbursement and makes their business trips convenient. An overall ceiling fixed for this card is also based on the status of the firm.

3. Smart Cards

It is a new generation card. Embedded in the smart card a microchip will store a monetary value. When a transaction is made using the card, the value is debited and the balance comes down automatically. Once the monetary value comes down to nil, the balance is to be restored all over again for the card to become operational. The primary feature of smart card is security. It prevents card related frauds and crimes. It provides communication security as it verifies whether the signature is genuine or not. The card also recognizes different voices and compares with the recorded original voice. It is used for making purchases without necessarily requiring the authorization of Personal Identification Number as in a debit card. Smart card is an electronic purse which attempts to prove to be a panacea for all problems associated with traditional currency. In India, the Dena Bank launched the Smart Card in Mumbai.

4. Debit Cards

Credit cards have proliferated during the last couple of years in all countries and have became an acceptable alternative to paper currency. The developed countries like USA has moved a step further. Debit card, an electronic product has become more and more popular in these countries.

Just like credit card, the debit card holder can present the card to the merchant, sign sales slip and forget about it, The purchase amount is automatically deducted or debited to the account of card holder electronically and would appear in the monthly statement of account. The debit card programme requires the customer to open an account with the bank which is not generally required in case of a credit card.

This system requires a terminal known as the Point of Sale Terminal at every point of purchase. The customer, on making the purchase, inserts the card which has a magnetic strip at the back, into the blot of the machine, while the merchant enters the value of the transaction. The customer meanwhile, keys in the Personal Identification Number which is known only to the card holder and the bank. The machine places an automatic call, checks the balance in the account and reduces the balance to the extent of the transaction value. The merchant's account, in turn, is credited for all his transactions on the next day.

Differences between Credit Card and Debit Card

1. The credit card is a ‘pay later’ product whereas a debit card is a 'pay now product'.
2. In the case of credit card, the holder can avail of credit for 30 to 45 days whereas in a debit card the customer's account is debited immediately.
3. No sophisticated telecommunication system is required in credit card business. The debit card programme requires installation of sophisticated communication network.
4. Opening a bank account and maintaining a required amount are not essential in a credit card. A bank account and keeping a required amount to the extent of transaction are essential in a debit card system.
5. Possibility of risk of fraud is high in a credit card. The risk is minimised through Personal Identification Number in debit card programme.

5. ATM Card

An ATM (Automatic Teller Machine) card is useful to a card holder as it helps him to withdraw cash from banks even when they are closed. This can be done by inserting the card in the ATM installed at various bank location.

12.4 PARTIES TO A CREDIT CARD

There are three parties to a credit card, the card holder, the issuer and the member establishments.

1. **Issuer :** The banks or other card issuing organisations.
2. **Cardholders :** Individuals, corporate bodies and non-individual and non-corporate bodies such as firms
3. **Member Establishments:** Shops and service organisations enlisted by credit card issuer who accept credit cards.

The member establishments may be a business enterprise dealing in goods and services such as retail outlets, departmental stores, restaurant, hotels, hospitals, travel agencies, petrol bunks etc.

Member establishments have to pay a certain percentage of discount on the credit card transactions to the issuer. Some organisations charge a specified sum as service charge. For instance, Indian Railways levy a service charge of Re.1 per ticket in addition to the fare.

Member Affiliate : There is one more party to the credit card, in the case of tie up arrangement, called Member Affiliate.

The issuer, may sometimes, enter a tie up arrangement for issuance of credit cards with other organisations. Such organisations are called Member Affiliates. In such cases, the organisations which have tie up arrangements also issue cards of the issuer to their clients. Credit cards issued by Member Affiliates contain the name and logo of the Member Affiliate on the face of the card, besides name and logo of the issuer. This arrangement enlarges the scope and operations of the credit card.

Many banks have tie up arrangement with Master Card International and Visa International. These organisations allow cardholders of one bank to use their cards in Member Establishment of another bank. The bank in whose fold the member establishment falls, called the Acquiring Bank, pay the amount to the merchant less his discount and the transaction is routed through either Master card or VISA who act as the clearing agencies. Master Card or VISA route the transaction through their network to the issuing bank which in turn makes payment to the acquiring bank. The issuing bank gets a percentage of the merchant discount as stipulated by the either Master Card or Visa.

12.5 PROCEDURE AT THE TIME OF PURCHASE AT MEMBER ESTABLISHMENTS

When a card holder intends to make purchases he presents his credit card for payment. The member establishment scrutinizes the card with reference to the following:

1. The validity period of the card has not expired.
2. The card has not been hot listed as per the latest 'hot list'/ warning bulletin. Whenever bank receives information about card lost/withdrawn/ cancelled it issues a warning letter. The hot list gives the latest list of invalid cards and supersedes all warning bulletin.
3. The signature of the card holder tallies with the specimen signature on the credit card.
4. The card has not been tampered within any manner.

On being satisfied with the validity of the credit card, the merchant proceeds in the following way:

1. Obtain the impression of the card with the help of the imprinter.
2. Obtain cardholder's signature in the space provided and check whether signature tallies with the signature on the card.

3. Prepare a chargeslip in triplicate giving all details. Give one copy to the consumer, keep one copy for records and forward one copy to the bank.

Procedure for reimbursement

The following procedure is followed for reimbursement to member establishments:

1. The merchant can claim reimbursement from the designated branches of bank.
2. All transactions emanating during the day are consolidated in the Summation Sheet cum BAR in triplicate.
3. The summation sheet cum BAR in duplicate along with the Bank's copy of the chargeslip should be submitted to the designated branch for reimbursement.
4. Reimbursement should be obtained within 30 days from the date of chargeslips.
5. The banks after deducting commission credit the amount of claim to the Member Establishment's Account or pay by D/D as earlier agreed.

Facilities offered to card holders

The various facilities offered to cardholders are described below:

1. Making purchase/availing of services at any of the member establishments.
2. Cash withdrawals at any of the branches of the issuer/member affiliate of the issuer to meet emergent requirements.
3. Add-on facility for family members. The spouse or children are entitled to use the card for making purchases.
4. Free credit period ranging from 15 to 45 days.
5. ATM facility at selected centres.

6. Wide range of insurance facilities are available which include personal accident insurance, cover for accidental death, baggage insurance, purchase protection cover against risk of fire, strike, theft etc. during transportation and concessional premium rates for personal accident insurance and medi-claim.

12.6 BENEFITS OF CREDIT CARDS

Credit cards confer a number of advantages on cardholders, issuers and member establishments. The benefits of credit cards to various parties are given below:

(a) Card Holders

1. Credit cards are simple to operate and easy to carry. The holders are relieved from the risk of carrying cash or cheque book with them.
2. A card is a convenient method of payment for goods and services. The holders have the option to purchase goods and services and pay conveniently at a later date in manageable instalments compatible with their household budgets.
3. Owing to revolving nature of credit, the customer can take advantage of it as and when he pleases within the overall limit.
4. Cash can be obtained at any branch of the issuer. The ATM facility is extended to cardholders who need not stand in queues and spend time unnecessarily at banks. By just inserting a card into an ATM, the holder can withdraw crisp new notes at any time of day or night.
5. Overdraft facility is given to card holders who are entitled to spend more than their actual limit. The amount of overdraft depends on the holder's past credit rating.
6. The purchasing power of the card holder increases to the extent of credit limit given in the card. If wisely used by consumers, credit cards can provide them extra money interest free. All that one has to do is to settle the bill in time.

7. Credit cards provide a certain degree of prestige to the holder. The status which one gets is not only because of his membership in a credit card organisation but because the card at once makes him great in a part of wider phenomenon. Visa, American Express and Master Card are all prestigious international organisations spread over 50 to 60 countries and their affiliated cards being acceptable in thousands of establishments all over the world.

(b) Issuers

1. Credit cards offer high profit for the banks. They get commission or discount, usually 2.5 per cent, on sale through credit cards. An interest charge of 1.5 per cent is made on a1l outstandings. Thus, a single transaction through credit card, assuming the customer does not repay within the stipulated period will fetch income of 5 per cent to the bank which works out as much as 60 per cent per annum; miles ahead of the prime lending rate of many banks. As more and more take advantage of the credit facility the credit card service becomes more profitable.
2. Where the card is issued to non-account holders, it may help to get new customers.
3. A credit card system helps control bank cost as it reduces the number of cheques issued by the customers.

(c) Member Establishment

1. The merchant has guarantee of payment and his account is credited immediately on submitting the chargeslip into his bank. No bad debt arises in credit card transactions.
2. A good cash flow is established because of the speedy settlement of bills by banks.
3. The acceptance of card in lieu of cash reduces security risk.

4. Member establishments are able to offer credit facility to their customers without setting up their own credit arrangements.

5. More and more people accept the practical advantage of credit cards and turn to suppliers who accept the cards in settlement. This helps increase the volume of business to member establishments.

12.7 DEMERITS OF'CREDIT CARDS

The credit card is not risk-free and all players associated with it have to face an element of risk associated with it.

(a) Card Holders

1. The card holders are burdened with service charge, annual fee, membership fee, etc. A high rate of interest is charged for delayed payment. A minimum of 5-10 per cent on monthly purchases apart from the additional charges are to be paid in case the consumers postpone the payment beyond the stipulated credit period. According to a recent survey, 65% of card holders are ignorant about the high interest charged on outstanding balance.

2. Credit cards tempt the holders for more purchases beyond their income and repaying capacity.

(b) Issuers

1 The cost involved in the credit card business is high which include cost of plastic card to be imported, cost of information, cost of placing and marketing cards, cost on staff to monitor processing of applications and to carry out credit checks on applicants etc. Unless the number of card holders and the volume of business is high the credit card business will not be a profitable one.

2. The menace of frauds perpetuated by holders of bogus cards and sometimes in collusion with the member establishments is the major problem for the issuers.

3. The average utilisation of credit card is only 20 per cent to 30 per cent in India.

The under utilisation of this facility erodes the profitability of banks.

(c) Member Establishment

1. The commission to be paid to the issuing banks/credit card organisation is heavy.
2. Some banks make delay in payment due to lack of adequate system and trained personnel which affect the cash flow of the member establishments.

12.8 CREDIT CARD BUSINESS IN INDIA

Credit cards are relatively new to India. Andhra Bank and Central Bank of India introduced credit cards in 1981. As of now there are more than a dozen major banks, Indian and Foreign, which have entered this line of business, besides some non-banking institution. Since the plastic money has today become as good as legal tender more people are using them in their day-to-day activities.

The features of credit cards issued by major banks are described below:

1. Andhra Bank

Andhra Bank introduced Andhra Bancard in 1981 having linkage with VISA and Japan Credit Bureau International Cards. It has now a membership around 1,00,000 and member establishments around 5400 allover the country with annual billing is Rs.120 crores.

Features of Andhra Bancard

1. Open to non-account holders also.
2. Individuals with assured income of Rs.12,OOO per annum are eligible to get the card.
3. Credit is allowed free of charge if the account is settled within15 days from the date of settlement.

4. Service charge of 2.5 per cent per month is collected on the unpaid balance amount.
5. Advance facility of Rs.1,000 is allowed twice a month at places other than the card holders' domicile.
6. The cash advance handling charges are levied at 3% of the amount availed as advance.
7. The card is valid for two years and renewed thereafter periodically.
8. Membership fee and annual subscription is charged for individual members, add-on cards and corporate cards at the prescribed rates.
9 Fatal accident insurance coverage by air travel upto Rs.50,000 is available to classic cardholders.
10. It is tied up with the world wide Master Card system.

2. Central Bank

The Central Bank issued Central Card in 1981. It has a membership of 1,00,000 and member establishments around 10,000 with annual billing of Rs.65 crores.

Features

1. It is open to those having savings or current account with sufficient balance and satisfactory dealing with the bank.
2. The cards are issued to individuals with and without add-on facility.
3. Free credit is allowed for three weeks after which interest is charged.
4. Service charge of Rs.50 per annum is levied if not utilised atleast for Rs.2,000 during the period.

3. Bank of Baroda

Bank of Baroda introduced BOB Card in 1985. Its membership is around 2.8 lakhs and member establishments are approximately 15,000. It has an annual transaction of about Rs.120 crores.

Features

1. Open only to account holders with well conducted accounts for atleast two years and having an annual income of Rs. 75,000 or more.
2. The facility is extended to family members. Rs.100 per annum for each add-on member is charged.
3. Cash advance facility not exceeding Rs.5,000 is allowed for a period of 15 days.
4. Introduced BOB CARD EXCLUSIVE offering certain exclusive benefits to the card holders.

4. Canara Bank

CAN CARD, Canara Bank's credit card was launched in August 1987.

Features

1. Can Card is issued to customers as well as non-customers of the bank.
2. Cash withdrawals upto 20% of the card limit is allowed.
3. Add-on facility is given to family members of card holders. Add on cards provide all benefits including insurance coverage of main card holders except cash withdrawals.
4. Valid for one year initially subject to renewal after expiry.
5. It is basically a charge card with no facility for payment of bills in installments.
6. Bills are sent once in a month and holders are given a time upto 15 days from the date of bill for payment.
7. Right from the date of issue of the card, the holder is covered by insurance against

the risk of death due to accident upto Rs. one lakh.

8. Under CAN COMFORT Scheme, insurance cover against the risk of death or injury due to accidents for amounts ranging from Rs.One lakh to Rs.10 lakhs is available. It also offers a variety of medi-claim plans to cover hospitalisation expenses.

5. Bank of India

Bank of India introduced INDIA GARD in 1988 and Taj Premium Card in 1990 in association with Taj Group of Hotels. Both these cards are affiliated to Master Card International.

Features

1. Issued to account holders having a well run account for about two years.
2. The membership fee is Rs. 100 per annum plus services charge is 15%.
3. Add-on-facility for a maximum of two members is available at a cost of Rs. 50 per head.
4. Cash upto Rs. 3000 a month can be withdrawn from any of the branches.
5. Free flight insurance coverage upto Rs. 1,00,000.

12.9 FUTURE PROSPECTUS

There are around four million credit card holders in India. Over 80,000 establishment in the country accept credit card. The credit card market is worth about Rs. 1,900 crores. The credit card industry is growing at an average rate of 35 per cent per year. Despite the impressive pattern of growth, India as a market is in a fairly nascent stage with credit card penetration amounting to just 15% of the customers. Compared to other countries in the region, India's card holders-base is relatively small.

With the economic growth gradually out-pacing population growth and with a large number of affluent middle class, the potential market that India holds is immense. It

is estimated that in the next ten years India will have a credit card population second to USA. According to few top banking professionals, the credit card business will grow by over 100% every year for the next five years.

To realise the potential in the credit card market the following suggestions are made :

1. Reduce the membership and annual subscription fees.
2. Encourage member establishments to accept credit cards for routine items also.
3. Make the features of cards convenient to middle class people.
4. Enhance the cash withdrawal limits.
5. 80% of the card holders are in metropolitan areas. So, workout strategies to popularise the credit card among people in semi urban and rural areas.

12.10 SUMMARY

The unparalleled growth of the services industry accompanies by the development in economic, social, cultural and technological spheres have contributed to the emergence of credit cards. Credit cards provide convenience and safety to the buying process. Besides, they enable an individual to purchase certain products/services without paying immediately. The buyer need only to present the credit card at the cash counter and to sign the bill. Credit cards are considered as a good substitute for cash and cheques. The reason for their popularity has now shifted from being recognized as a status symbol to being a convenience and security with worldwide acceptance. Indian banks have enters the credit card business in a big way during the last few years. Selling goods on credit basis, depending upon the credit credibility of the consumer has been the practice of the merchants from time immemorial. Such a system helped both the consumer and the seller/creditors. In this context, credit cards have been introduced as a viable means of dealing goods on credit with an aim to expand sales and thereby built a strong customer base.

12.11 KEYWORDS

Credit Card: Any card used as a payment device that accesses a customer's financial resources for a payment, the card being used during travel or at home, for purchases or at the Automated Teller Machines (ATMs) for undertaking credit or debit transaction.

Debit Card: Card that electronically debits the account of a customer while making payment on purchases.

ATM: Any Time Money, where customers of a bank are provided with the facility of using their bank account 24 hours a day and throughout the year for the purposes of transacting some of the basic banking functions like deposits, withdrawal etc.

Smart Card: A plastic card, as different from a magnetic stripe card, that is embedded with a computer microchip, designed to carry a far greater amount of intelligence and memory capacity.

12.12 SELF ASSESSMENT QUESTIONS

1. What is a credit card? Explain the various types of credit cards.
2. Discuss the advantages and disadvantages of credit card.
3. Describe the facilities offered to credit holders.
4. Explain the features of credit cards issued by various banks in India.

12.13 SUGGESTED READINGS

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LESSON-13
VENTURE CAPITAL

STRUCTURE

13.0 Objective
13.1 Introduction
13.2 Concept of Venture Capital
13.3 Scope of Venture Capital
13.4 Steps to Provide Venture Capital
13.5 Importance of Venture Capital
13.6 Origin
13.7 Initiative in India
13.8 Methods of Venture Financing
13.9 Indian Experience
13.10 Suggestion for the growth of venture capital funds
13.11 Summary
13.12 Keywords
13.13 Self Assessment Questions
13.14 Suggested Readings

13.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Understand the concept, scope and mechanism of venture capital.

(b) Make a historical perspective about venture capital.

(c) Explain the importance of venture capital.

(d) Evaluate the scenario of venture capital in India.

13.1 INTRODUCTION

Venture capital is a growing business of recent origin in the area of industrial financing in India. The various financial institutions set up in India to promote industries have done commendable work. However, these institutions do not come upto the benefit of risky ventures when they are undertaken by new or relatively unknown entrepreneurs. They contend to give debt finance, mostly in the form of term loans to the promoters and their functioning has been more akin to that of commercial banks. The financial institutions have devised schemes such as seed capital scheme, risk capital fund etc., to help new entrepreneurs. However, to evaluate the projects and extend financial assistance they follow the criteria such as safety, security, liquidity and profitability and not potentiality. The capital market with its conventional financial instruments/schemes does not come much to the benefit or risky venture. New institutions such as mutual funds, leasing and hire purchase company's have been established as another source of finance to industries. These institutions also do not mitigate the problems of new entrepreneurs who undertake risky and innovative ventures.

India is poised for a technological revolution with the emergence of new breed of entrepreneurs with required professional temperament and technical know how. To make the innovative technology of the entrepreneurs a successful business venture, support in all respects and more particularly in the form of financial assistance is all the more essential. This has necessitated the setting up of venture capital financing Division/companies during the latter part of eighties.

13.2 CONCEPT OF VENTURE CAPITAL

The term 'Venture Capital' is understood in many ways. In a narrow sense, if refers to, investment in new and tried enterprises that are lacking a stable record of growth.

In a broader sense, venture capital refers to the commitment of capital as shareholding, for the formulation and setting up of small firms specializing in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is a

simultaneous input of skill needed to set up the firm, design its marketing strategy and organise and manage it. It is an association with successive stages of firm's development with distinctive types of financing appropriate to each stage of development.

Venture capital is long term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalist pool their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium.

A venture capital company is defined as "a financing institution which joins an entrepreneur as a co-promote in a project and shares the risks and rewards of the enterprise."

Features of venture capital

Some of the features of venture capital financing are as under:

1. Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.
2. Investment is made only in high risk but high growth potential projects.
3. Venture capital is available only for commercialisation of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.
4. Venture capitalist joins the entrepreneur as a co-promoter in projects and share the risks and rewards of the enterprise.
5. There is continuous involvement in business after making an investment by the investor.
6. Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestments.

7. Venture capital is not just injection of money but also an input needed to setup the firm, design its marketing strategy and organise and manage it.

8. Investment is usually made in small and medium scale enterprises.

Disinvest Mechanism

The objective of venture capitalist is to sell of the investment made by him at substantial capital gains. The disinvestments options available in developed countries are: (i) Promoter's buy back (ii) Public issue (iii) Sale to other venture capital Funds (iv) Sale in OTC market and (v) Management buyouts. .

In India, the most popular investment route is promoter's buy back. This permits the ownership and control of the promoter in tact. The Risk Capital and Technology Finance Corporation, CAN -VCF etc., in India allow promoters to buy back equity of their enterprise.

The public issue would be difficult and expensive since first generation entrepreneurs are not known in the capital market. The option involves high transaction cost and also less feasible for small ventures on account of high listing requirements of the stock exchange.

The OTC Exchange in India has been set up in 1992. It is hoped that OTCEI would provide disinvestment opportunities to venture capital firms. The other investment options such as management buyout or sale to other venture capital fund are not considered appropriate in India.

13.3 SCOPE OF VENTURE CAPITAL

Venture capital may take various forms at different stages of the project. There are four successive stages of development of a project viz. development of a project idea, implementation of the idea, commercial production and marketing and finally large scale investment to exploit the economics of scale and achieve stability. Financial institutions and banks usually start financing the project only at the second or third stage but rarely

from the first stage. But venture capitalists provide finance even from the first stage of idea formulation. The various stages in the financing of venture capital are described below:

(1) Development of an Idea - Seed Finance: In the initial stage venture capitalists provide see capital for translating an idea into business proposition. At this stage investigation is made in-depth which normally takes a year or more.

(2) Implementation Stage - Start up Finance: When the firm is set up to manufacture a product or provide a service, start up finance is provided by the venture capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

(3) Fledging Stage :- Additional Finance: In the third stage, the firm has made some headway and entered the stage of manufacturing a product but faces teething problem. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

(4) Establishment Stage - Establishment Finance: At this stage the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that is can reap economics of scale and attain stability. At the end of the establishment stage, the firm is listed on the stock exchange and at this point the venture capitalist disinvests their shareholdings through available exist routes.

Before investing in small, new or young hi-tech enterprises, the venture capitalists look for percentage of key success factors of a venture capital project. They prefer projects that address these problems.

After assessing the viability of projects, the investors decide for what stage they should provide venture capital so that it leads to greater capital appreciation. All the above stages of finance involve varying degrees of risks and venture capital industry, only after analysing such risks, invest in one or more. Hence they specialize in one or

more but rarely all

13.4 STEPS TO PROVIDE VENTURE CAPITAL

a) Selecting Investment proposal

Depending on thrust with which venture capitalist is operating the business plan of the entrepreneur is studied by venture capitalist. Selection of the venture is made by viewing the stage and types of investments it is evaluating. Internal as well as external factors are considered, internal being management and technology and external are like industry environment, industry structure, market- potential etc.

b) Financial analysis

Financial analysis of venture capital proposal is not similar to convententional investment proposals. It has to be appreciated that such investment proposals are idea based and growth based rather than 'asset-based'. Venture Capitalist is more interested in the value of the company at time of potential exit as this would form the basis of his own profitability, which depends crucially on his capital gains at exit time.

c) Mode of investment

In what form venture capital is to be provided, is a crucial decision. All types of investment instruments available are to be weighed against 'risk-return' model in the given context. The venture capital deal has to be structured targeting maximum value of the venture capitalist.

d) Monitoring

Like other financing agencies, venture capitalist continue to have association with assisted project. They play an active role in the management of the venture unlike other financing agencies. Their target is 'investment nurturing' so their involvement is more intimate and constant during the entire-life of the investment.

They ensure proper utilisation of assistance provided, check cost and time over run and make sure that no statutory defaults are made. They seek periodical reports, visit the plant, have personal discussion with the entrepreneurs, get feed back from resource persons and feed back through nominee directors.

e) Valuing the portfolio

Venture Capitalist has an ultimate target to exit at an opportune time. To decide opportune time it is necessary that he constantly values his portfolio. Only on valuing the portfolio he gets an idea about his capital gain. He targets to assess the fair value of the investment at a particular point of time. The valuing technique should be such which incorporates accounting and financial point of view as well as stages of investment The valuation basis should be consistent fair and conservative.

f) Exit

Exit is a pre requisite for capital gain to the venture capitalist. Exit time has to be planned broadly at the time of entering contract for venture capital. Exit time decision is not solely of venture capitalist. Interest of the entrepreneur is also to be taken in account to decide exit time. Exit can be by disposing of investment through many avenues like :

A) Making public issue

B) Sale to entrepreneurs

C) Private placement to a new investor

13.5 IMPORTANCE OF VENTURE CAPITAL

Venture Capital is of great practical value to every corporate enterprise in modern times.

I. Advantage to Investing Public

1. The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business they would be able to stop malpractices by management.

2. Investor have no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyses the prospects of the business.

3. The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome it.

II. Advantages to Promoters

1. The entrepreneur for the success of public issue is required to convince tens of underwriters, brokers and thousands of investors but to obtain venture capital assistance, he will be required to sell his idea to justify the officials of the venture fund.

2. Public issue of equity shares has to be proceeded by a lot of efforts viz. necessary statutory sanctions, underwriting and brokers arrangement, publicity of issue etc. The new entrepreneurs find it very difficult to make underwriting arrangements which involves a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.

3. Costs of public issues of equity share often range between 10 per cent to 15 per cent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above, to

incur recurring costs for maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc. These items of expenditure can be ill afforded by the business when it is new. Assistance from venture fund does not require such expenditure.

III. General

1. A developed venture capital institutional set up reduces the time lag between a technological innovation and its commercial exploitation.
2. It helps in developing new processes/products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.
3. Venture capital acts as a cushion to support business borrowings, as bankers and investors will not lend money with, inadequate margin of equity capital.
4. Once venture capital funds start earning profits, it will be very easy for them to raise resources from primary capital market in the form of equity and debts. Therefore, the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing business when venture fund disposes its own holding. This mechanism will help to channelise investment in new high-tech business or the existing sick business. These business will take-off with the help of finance from venture funds and this would help in increasing productivity, better capacity utilisation etc.
5. The economy with well developed venture capital network induces the entry of large number of technocrats in industry, helps in stabilizing industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development.

6. A venture capital firm serves as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start ups.

7. It also paves the way for private sector to share the responsibility with public sector.

13.6 ORIGIN

Venture capital as a new phenomenon originated in USA and developed spectacularly world wide since the second half of the seventies. American Research and Development Corporation, founded by Gen. Doriot soon after the Second World War, is believed to have heralded the institutionalisation of venture capital in the USA. Since then the industry has developed in many other countries in Europe, North America and Asia. The real development of venture capital took place in 1958 when the Business Administration Act was passed by the US Congress. In USA alone there are 800 venture capital firms managing around $40b of capital with annual accretions of between $ Ib and 5b. It is reported that some of the present day giants like Apple, Micro soft, Xerox etc. are the beneficiaries of venture capital.

UK occupies a second place after US in terms of investment in venture capital. The concept became popular in late sixties in UK. The Government's Business Expansion Scheme which permitted individuals to claim tax relief for investment in companies not listed in stock exchange led to the success of venture capital in UK. The CHARTER House Development Limited is the oldest venture capital company established in 1934 in UK. The Bank of England established its venture capital company in late 40's. The UK witnessed a massive growth of industry during 70's and 80's. During 1988 there were over 1000 venture capital companies in UK which provided Rs.3700 crores to over 1500 firms.

The success of venture capital in these countries prompted other countries to design and implement measures to promote venture capital and their total commitment

have been rising.

13.7 INITIATIVE IN INDIA

Indian tradition of venture capital for industry goes back more than 150 years when many of the managing agency houses acted as venture capitalists providing both finance and management skill to risky projects. It was the managing agency system through which Tata Iron and Steels and Empress Mills were able to raise equity capital from the investing public. The Tatas also initiated a managing agency hours, named Investment Corporation of India in 1937 which by acting as venture capitalist, successfully promoted hi-tech enterprises such as CEAT tyres, Associated Bearings, National Rayon etc. The early form of venture capital enabled the entrepreneurs to raise large amount of funds and yet retain management control. After the abolition of managing agency system, the public sector term lending institutions met a part of venture capital requirements through seed capital and risk capital for hi tech industries which were not able to meet promoters contribution. However, all these institutions supported only proven and sound technology while technology development remained largely confined to government labs and academic institutions. Many hi-tech industries, thus, found it impossible to obtain financial assistance from banks and other financial institutions due to unproven technology, conservative attitude, risk awareness and rigid security parameters.

Venture capital's growth in India passed through various stages. In 1973, R.S. Bhatt Committee recommended formation of Rs.100 crore venture capital fund. The Seventh Five Year Plan emphasised the need for developing a system of funding venture capital. The Research and Development Cess Act was enacted in May 1986 which introduced a cess of 5% on all payments made for purchase of technology from abroad. The levy provides the source for the venture capital fund.

United Nations Development Programme in 1987 on behalf of government examined the possibility of developing venture capital in private sector. Technology

Policy Implementation Committee in the same year also recommended the same provision. Formalised venture capital took roots when venture capital guidelines were issued by Comptroller of Capital Issues in November 1988.

Guidelines

The following are the guidelines issued by the Government of India.

1. The public sector financial institutions, State Bank of India, scheduled banks foreign banks and their subsidiaries are eligible for setting the venture capital funds with a minimum size of Rs.l0 crore and a debt equity ratio of 1:1.5. If they desire to raise funds from the public, promoters will be required to contribute a minimum of 40 per cent of capital. Foreign equity upto 25 per cent subject to certain conditions would be permitted.

   The guidelines provide for Non Resident Indians investment upto 74 per cent on a repatriable basis and 25 per cent to 40 per cent on a non repatriable basis. It should invest 60 per cent of its funds in venture capital activity. The balance amount can be invested in new issue of any existing or new company in equity, cumulative convertible preference shares, debenture, bonds or any other security.

2. The venture capital companies and venture capital funds can be set up as joint venture between stipulated agencies and non institutional promoters but the equity holding of such promoters should not exceed 20 per cent and should not be largest single holder.

3. Venture capital assistance should go to enterprises with a total investment of not more than Rs.10 crore

4. The venture capital company (VCC) /Venture Capital Fund (VCF) should be managed by professionals and should be independent of the parent organisation.

5. The VCC/VCF will not be allowed to undertake activities such as trading, brooking, money market operations, bills discounting, inter corporate lending.

They will be allowed to invest in leasing to the extent of 15 per cent of the total funds developed. The investment on revival of sick units will be treated as a part of venture capital activity.

6. Listing of VCCs/VCF can be according to the prescribed norms and underwriting of issues at the promoter's discretion.

7. A person holding a position or full time chairman/president, chief executive, managing director or executive director/whole time director in a company will not be allowed to hold the same position simultaneously in the VCC/VCF.

8. The Venture Capital assistance should be extended to

   (i) The enterprise having investment upto Rs.10 crores in the project.

   (ii) The technology involved should be new and untried or it should incorporate significant improvement over the existing technologies in India.

   (iii) The promoters should be new, professionally or technically qualified with inadequate resources.

   (iv) The enterprise should be established in the company form employing professionally qualified person for maintenance of accounts.

9. Share pricing at the time of disinvestment by a public issue or general sale offer by the company or fund may be done subject to this being calculated an objective criteria and the basis disclosed adequately to the public.

13.8 METHODS OF VENTURE FINANCING

Venture capital is available in three forms in India

1. Equity
2. Conditional Loan
3. Income Note.

1. **Equity:** All VCF's in India provide but generally their contribution does not exceed 49% of the total equity capital. VCF's buy equity shares of an enterprise with an intention to ultimately sell of to make capital gain.

2. **Conditional Loan :** A conditional loan is repayable in the form of royalty after the project generates sales. No interest is paid on such loans. VCF's charge royalty ranging between 2 and 15 per cent. Some VCF's give a choice to the entrepreneur to pay a high interest rate instead of royalty on sales once the project becomes commercially sound.

3. **Income note :** An income note combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales. Funds are made available in the form unsecured loans at 9 per cent per year during development phase. In addition to interest, royalty on sales could also be charged.

13.9 INDIAN EXPERIENCE

The need of venture capital financing was highlighted by the then Union Finance Minister while presenting the 1986-87 Finance bill. In May 1986, the Research and Development Cess Bill was introduced in Parliament. The basic idea of this bill was to levy cess on import of technology in order to raise resources for a venture capital fund to assist enterprises based on indigenous technology and skill. The bill does not seem to have made much progress. However, in the budget speech of 1988-89 the finance minister again referred to the need for venture capital for new entrepreneurs. In the last week of November 1988, the Government of India finally issued the long awaited guidelines for venture capital financing. These guidelines fulfill the promise made by the finance minister. It stared getting momentum. By January 1994 ten venture capital companies had already become operational. The present players can be broadly classified into four categories:

a) Companies set up by financial institutions.

b) Companies set up by state level financial institution.

c) Companies set up by commercial banks, and

d) Companies set up in the private sector.

Some of the companies raised resources under close ended venture capital funds (with maturity of around 10 to 12 years) and acted primarily as managers of these funds. The others raised equity capital to support their investment operations.

The restrictions imposed in 1988 guideline did not let venture capital culture flourish. But still appreciating potential of the medium, Finance Act 1995 provided income tax exemption on any income by way of dividends or long term capital gains of a venture capital fund or company. Such exemption is valid only if shares are transferred after 3 years. These exemptions were only if the Venture Capital Companies are registered with SEBI. It was in February 1996 SEBI came out with fresh guidelines in form of a consultative paper. These met most of the demands of the Indian Venture Capital Association. In December 1996 SEBI (Venture Capital Fund) Regulations 1996 were released.

13.10 SUGGESTION FOR THE GROWTH OF VENTURE CAPITAL FUNDS

Venture capital industry is at the take off stage in India. It can play a catalytic role in the development of entrepreneurship skill that remains unexploited among the young and energetic technocrats and other professionally qualified talents. It can help promote new technology and hi-tech industries, which involve high risk but promises attractive rate of return. In order to ensure success of venture capital in India, the following suggestions are offered:

1. Exemption/Concession for Capital Gains

Capital gains law represents a hurdle to the success of venture capital financing. The earnings of the funds depend primarily on the appreciation in stock values. Further, the capital gains may arise only after 3 to 4 years of investment and that the projects,

being in new risky areas, may not even succeed. Capital gains by corporate bodies in India are taxed at a much higher rate than gains of individual investors. Taking into account the high investment risk and long gestation period this is a deterrent to the development of VCFs.

The benefit of capital gains, under section 48 of the Act is not significant. Hence, it would be advisable that all long term capital gains earned by VCCs should be exempted from tax or subjected to confessional flat rate. Further, capital gains reinvested in new ventures should also be exempted from tax.

2. Development of Stock Markets

Guidelines issued by finance ministry provides for the sale of investment by way of public issue at the price to be decided on the basis of book value and earning capacity. However, this method may not give the best available prices to venture fund as it will not be able to consider the future growth potential of the invested company.

One of the major factor which contributed to the success of venture funds in the West is development of secondary and tertiary stock markets. These markets do not have listing requirements and are spread over all important cities and towns in the country. These stock markets provide excellent disinvestment mechanism for venture funds. In India, however, stock market is not developed beyond a few important cities.

Success of venture capital fund depends very much upon profitable disinvestment of the capital contributed by it. In US and UK, secondary and tertiary markets helped in accomplishing the above. However, in India, promotion of such makes is not feasible in the prevailing circumstances as such laissez faire policy may attack persons with ulterior motives in the business to the determent of the general public. However, stock market operation may be started at many more big cities where, say, the number of stock exchanges can be increased to 50. Further, permission to transact in unlisted securities with suitable regulation will ensure first hand contact between venture fund and investors.

3. Fiscal Incentives

Fiscal incentives may be given in the form of lowering the rate of Income Tax. It can be accomplished by :

(i) Application of provisions applicable to non-corporate entities for taxing long term capital gains.

(ii) An allowance to funds similar to Section 80-CC of Income Tax Act, say 20 per cent of the investment in new venture which can be allowed as deduction from the income.

4. Private Sector Participation

In US and UK where the economy is dominated by private sector, development of venture fund market was possible due to very significant role played by private sector which is often willing to put money in high risk business provided higher returns are expected. The guidelines by finance ministry provide that non-institutional promoter's share in the capital of venture fund cannot exceed 20 per cent of total capital; further they cannot be the single largest equity holders. The private sector, because of this provision, may not like to promote venture fund business.

Promotion of venture funds by private sector, in addition to public financial institution and banks, is recommended as :

(a) Private sector is in advantageous position as compared to financial institutions and banks to pride managerial support to new ventures as leading industrial houses have a pool of experienced professional managers in all fields of management viz. marketing, production and finance.

(b) The leading business houses will be able to raise funds from the investing public with relative ease.

5. Review the Existing Laws

Today’s need is to review the constraints under various laws of the country and

resolve the issues that could come in the way of growth of the innovative mode of financing. The initiative on the part of the Government in the direction would see rapid growth of a new breed of venture capital assisted entrepreneurs.

13.11 SUMMARY

A financial service that is concerned with the provision of financial and other assistance to high technology, high-risk and high-return ventures are called venture capital. Venture capital is designed to suit the high expectation of entrepreneurs for high gains. The usual mode of venture financing involves the equity/seed capital provision. Financing high-risk ventures is the hallmark of venture financing. In addition to financing facility, venture capital also provides value-added services, such as business skills to investee firms. Venture capitalists employ certain methods to evaluate the desirability of their investments in new ventures. Venture capital financing originated in the USA after World War II, and thereafter spread to other countries. Venture capital is quite popular in India too, with companies, both in the public and private sectors, setting up venture capital funds. Financing by a venture capitalist involves different types such as R & D financing, starting financing, expansion financing, replacement financing, turnaround financing, etc. For a venture capitalist, the sources of funds include borrowings from banks and financial institutions, besides their own capital. A popular mode of venture financing includes ‘buy-out deals’ whereby a venture capitalist buys the management holding of an enterprise. Venture capitalist provide investment-nurturing services as part of their efforts in building up a strong relationship with the investee firms, with a view of optimizing the benefits of venture capital investments.

13.12 KEYWORDS

Venture Capital: A high-risk and high-return capital fund for a high technology ventures, usually in the form of equity financing.

Venture Capital Fund: Fund created by venture capitalists to support entrepreneurs with high-risk capital funds.

Start-up Financing: Financing needed for the product development, initial marketing and the establishment of product facilities.

13.13 SELF ASSESSMENT QUESTIONS

1. What is venture capital? Discuss the scope of venture capital in India.
2. Discuss the strategic role of venture capital in the development of a country.
3. Explain the various stages of venture capital financing.
4. Make suggestions for the success of venture capital in India.

13.14 SUGGESTED READINGS

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Subject	**:**	**Management of Financial Services**		

LESSON-14

DISCOUNTING, FACTORING AND FORFEITING

STRUCTURE

14.0 Objective
14.1 Introduction
14.2 Discounting
14.3 Factoring
14.4 Modus Operandi of the Factoring
14.5 Terms and Condition in a Factoring Agreement
14.6 Functions of Factoring
14.7 Types of Factoring
14.8 Factoring Vs. Discounting
14.9 Cost and Benefits of Factoring
14.10 Benefits of Factoring
14.11 Factoring in India
14.12 Forfeiting
14.13 Factoring Vs. Forfeiting
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14.15 Benefits of Forfeiting
14.16 Drawbacks of Forfeiting
14.17 Forfeiting in India
14.18 Summary
14.19 Keywords
14.20 Self Assessment Questions
14.21 Suggested Readings

14.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Understand the concepts of discounting, factoring and forfeiting.

(b) Explain the mechanism of factoring.

(c) List out the types, cost and benefits of factoring.

(d) Differenciate between factoring and forfeiting.

(e) Discuss the benefits and drawbacks of forfeiting.

(f) Present a scenario of factoring and forfeiting in India.

14.1 INTRODUCTION

In India, the financial services sector is developing at a faster rate so as to meet the emerging needs of the economy. Many innovative schemes have been introduced by this sector and one such area wherein it has been introduced is book-debt financing. Financial institutions try to extend their financial assistance to a larger cross-section of the trading community through book-debt financing. A kind of book-debt financing is already practiced in India by the commercial banks. It is nothing but bill financing. This type of financing is done either by way of direct purchase of bills of customers or discounting them.

14.2 DISCOUNTING

Generally, a trade bill arises out of a genuine credit trade transaction. The supplier of goods draws a bill on the purchaser for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months and in some cases for 9 months. The buyer of goods accepts the same and binds himself liable to pay the amount on the due date. In such a case, the supplier of goods has to wait for the expiry of the bill to get back the cost of the goods sold. It involves locking up of his working capital which is very much needed for the smooth running of the business or for carrying on the normal production process. It is where by the commercial banks enter into as a financier.

The commercial banks provide immediate cash by discounting genuine trade bills. They deduct a certain charge as discount charges from the amount of the bills and the balance is credited to the customer's account and thus, the customer is able to enjoy credit facilities against the discounting of bills. Of course, this discount charges include interest for the unexpired period of the bill plus some service charges. Bill financing is the most liquid one from the banker's point of view since, in time of emergencies, they can take those bills to the Reserve Bank of India for rediscounting purposes. In fact, it was viewed primarily as a scheme of accommodation for banks. Now, the situation is completely changed. Today it is viewed as a kind of loan backed by the security of bills.

Bill financing is superior to the conventional and traditional system of cash credit in many ways.

(i) First of all, it offers high liquidity, in the sense, funds could be recycled promptly and quickly through rediscounting.

(ii) It offers quick and high yield. The baker gets income in the form of discount charges at the time of discounting the bills.

(iii) Again, there is every opportunity to earn the spread between the rates of discount and rediscount.

(iv) Moreover, bills drawn by business people would never be dishonored and they are not subject to any fluctuations in their values.

(v) Cumbersome procedures to create the security and the positive obligations to maintain it are comparatively very fewer.

(vi) Even if the bill is dishonored, there is a simple legal remedy. The banker has to simply note and protest the bill and debt the customer's account. Bills are always drawn with recourse and hence, all the parties on the instrument are liable till the bill is finally discharged.

(vii) Above all, these bills would be very much useful as a base for the maintenance of reserve requirements like CRR and SLR.

It is for these reasons, the Reserve Bank of India has been trying its best to develop a good bill market in India. The Reserve Bank of India introduced a Bill Market Scheme as early as 1952 itself and thereafter, with some modifications. It has lowered the effective rate of interest on bill finance by 1% below the cash credit rate. Despite many efforts of the Reserve Bank of India to promote and develop a good bill market, bill financing forms barely 5% of the total credit extended by banks. The latest step of the Reserve Bank of India to promote the bill market is the launching of the factoring service organizations.

14.3 FACTORING

As stated earlier, a lot of working capital is tied up in the form of trade debts. Collection of debts, especially for the small-scale and medium scale companies is the biggest problem. The average collection period has been on the increase. Delays in collection process inturn lead to liquidity problems and consequently to delay in production and supplies. The peculiar situation in India is that a number of small scale units are catering to the requirements of a single large buyer. This large buyer is always known for his procrastination in paying his small suppliers. The crux of the problem is not so much the failure to pay altogether as the failure to pay on time. As a result, the interest cost of financing book debts is quite heavy. This increase in cost of capital reduces profit and competitiveness of a company particularly the small ones in the market. Ultimately, the small unit may become even sick. To overcome this situation, the factoring service has been conceived.

The word ‘Factor’ has been derived from the Latin word ‘Facere’ which means to ‘to make or to do’. In other words, it means ‘to get things done’. According to the Webster Dictionary ‘Factor’ is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 per cent payment. To put it in a layman's language, a factor is an agent who collects the dues of his client for a certain fee.

Robert W. Johnson states "factoring is a service involving the purchase by a financial organization, called a factor, of receivables owned to manufacturers and distributors by their customers, with the factor assuming full credit and collection responsibilities".

In the words of Kohok "factorings is an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods".

14.4 MODUS OPERANDI OF THE FACTORING

A factor provides finance to his client upto a certain percentage of the unpaid invoices which represent the sale of goods or services to approved customers. The modus operandi of the factoring scheme is as follows :

(i) There should be a factoring arrangement (invoice purchasing arrangement) between the client (which sells goods and services to trade customers on credit) and the factor, which is the financing organization.

(ii) Whenever the client sells goods to trade customers on credit, he prepares invoices in the usual way.

(iii) The goods are sent to the buyers without raising a bill of exchange but accompanied by an invoice.

(iv) The debt due by the purchaser to the client is assigned to the factor by advising the trade customers, to pay the amount due to the client, to the factor.

(v) The client hands over the invoices to the factor under cover of a schedule of offer along with the copies of invoices and receipted delivery challans or copies of R/R or L/R.

(vi) the factor makes an immediate payment upto 80% of the assigned invoices and the balance 20% will be paid on realization of the debt.

14.5 TERMS AND CONDITION IN A FACTORING AGREEMENT

The existence of an agreement between the factor and the client is central to the function of factoring. The main terms and conditions generally included in a factoring agreement are the following :

(i) Assignment of debt in favour of the factor,

(ii) Selling limits for the client,

(iii) Conditions within which the factor will have recourse to the client in case of non-payment by the trade customer,

(iv) Circumstances under which the factor will have recourse in case of non-payment,

(v) Details regarding the payment to the factor for his services, say for instance, as a certain percentage on turnover,

(vi) Interest to be allowed to the factor on the account where credit has been sanctioned to the supplier, and

(vii) Limit of any overdraft facility and the rate of interest to be charged by the factor.

14.6 FUNCTIONS OF FACTORING

As stated earlier the term ‘factoring’ simply refers to the process of selling trade debts of a company to a financial institution. But, in practice, it is more than that. Factoring involves the following functions :

(i) Purchase and collection debts

Factoring envisages the sale of trade debts to the factor by the company, i.e., the client. It is where factoring differs from discounting. Under discounting, the financier simply discounts the debts backed by account receivables of the client. He does so as an agent of the client. But, under factoring, the factor purchases the entire trade debts and thus, he becomes a holder for value and not an agent. Once the debts are purchased by the factor, collection of those debts becomes his duty automatically.

(ii) Credit investigation and undertaking of credit risk

Sales ledger management function is a very important one in factoring. Once the factoring relationship is established, it becomes the factor’s responsibility to take care of all the functions relating to the maintenance of sales ledger. The factor has to credit the customer’s account whenever payment is received, send monthly statements to the customers and to maintain liaison with the client and the customer to resolve all possible disputes. He has to inform the client about the balances in the account, the overdue period, the financial standing of the customers, etc. Thus the factor takes up the work of monthly sales analysis, overdue invoice analysis and credit analysis.

(iii) Credit investigation and undertaking of credit risk

The factor has to monitor the financial position of the customer carefully, since, he assumes the risk of default in payment by customers due to their financial inability to pay. This assumption of credit risk is one of the most important functions which

the factor accepts. Hence, before accepting the risk, he must be fully aware of the financial viability of the customer, his past financial performance record, his future ability, his honesty and integrity in the business world etc. For this purpose, the factor also undertakes credit investigation work.

(iv) Provision of Finance

After the finalization of the agreement and sale of goods by the client, the factor provides 80% of the credit sales as prepayment to the client. Hence, the client can go ahead with his business plans or production schedule without any interruption. This payment is generally made without any recourse to the client. That is, in the event of non-payment, the factor has to bear the loss of payment.

(v) Rendering Consultancy Service

Apart from the above, the factor also provides management services to the client. He informs the client about the additional business opportunities available, the changing business and financial profiles of the customers, the likelihood of coming recession etc.

14.7 TYPES OF FACTORING

The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc. In general, the factoring services can be classified as follows :

(i) Full service factoring or without recourse factoring

(ii) With Recourse Factoring

(iii) Maturity Factoring

(iv) Bulk Factoring

(v) Invoice Factoring

(vi) Agency Factoring

(vii) International Factoring

(i) Full Service Factoring

Under this type, factor provides all kinds of services discussed above. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility falls on the shoulders of the factor since the assumes the credit risk also. He can not pass on this responsibility to his client and hence, this type of factoring is also called 'Without Recourse' Factoring.

(ii) With Recourse Factoring

As the very name suggest, under this type, the factor does not assume the credit risk. In other words, if the debtors do not repay their dues in time and if their debts are outstanding beyond a fixed period, say 60 to 90 days from the due date, such debts are automatically assigned back to the client. The client has to take up the work of collection of overdue account by himself. If the client wants the factor to go on with the collection work of overdue accounts, the client has to pay extra charges called 'Refactoring Charges".

(iii) Maturity Factoring

Under this, the factor does not provide immediate cash payment to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire amount collected less factoring fees is paid to the client immediately. Hence it is also called 'collection Factoring'. In fact, under this type, no financing is involved. But all other services are available.

(iv) Bulk Factoring

Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring is resorted to when the factor is not fully satisfied with the financial condition of the client. The work

relating to sales ledger administration, credit control, collection work etc. has to be done by the client himself. Since the notification has been made, the factor simply collects the debts on behalf of the client. This is otherwise called as “Disclosed Factoring” or Notified Factoring”.

(v) Invoice Factoring

Under this type, the factor simply provides finance against invoices without undertaking any other functions. All works connected with sales administration, collection of dues etc. have to be done by the client himself. The debtors are not at all notified and hence they are not aware of the financing arrangement. This type of factoring is very confidential in nature and hence it is called ‘Confidential Invoice discounting’ or ‘Undisclosed Factoring’.

(vi) Agency Factoring

The word agency has no meaning as far as factoring is concerned. Under this type, the factor and the client share the work between themselves as follows :

(i) The client has to look after the sales ledger administration and collection work and

(ii) The factor has to provide finance and assume the credit risk

(vii) International Factoring

Under this type, the services of a factor in a domestic business are simply extended to international business. Factoring is done purely on the basis of the invoice prepared by the exporter. Thus, the exporter is able to get immediate cash to the extent of 80% of the export invoice under international factoring. International factoring is facilitated with the help of export factors and import factors.

(viii) Suppliers Guarantee Factoring

This type of factoring is suitable for business establishments which sell goods through middlemen. Generally, goods are sold through wholesalers, retailers or through middlemen. In such cases, the factor guarantees the supplier of goods against invoices raised by the supplier upon another supplier. The bills are assigned in favour of the factor who guarantees payment of those bills. This enables the supplier to earn profits without much financial involvement.

(ix) Limited Factoring

Under this type, the factor does not take up all the invoices of a client. He discounts only selected invoices on merit basis and converts credit bills into cash in respect of those bills only.

(x) Buyer Based Factoring

In most cases, the factor is acting as an agent of the seller. But under this type, the buyer approaches a factor to discount his bills. Thus, the initiative for factoring comes from the buyers' end. The approved buyers of a company approach a factor for discounting their bills to the company in question. In such cases, the claims on such buyers are paid by discounting the bills without recourse to the seller and the seller also gets ready cash. This facility is available only to reputed credit worthy buyers and hence it is also called selected buyer Based Factoring.

(xi) Seller Based Factoring

Under this type, the seller, instead of discounting his bills, sells all his accounts receivables to the factor, after invoicing the customers. The seller's job is over as soon as he prepares the invoices. Thereafter, all the documents connected with the sale are handed over to the factor who takes over the remaining functions. This facility is extended to reputed and credit worthy sellers and hence it is also called 'Selected Seller Based Factoring'.

14.8 FACTORING VS. DISCOUNTING

Factoring differs from discounting in many respects. They are:

(i) Factoring is a broader term covering the entire trade debts of a client whereas discounting covers only those trade debts which are backed by accounts receivables.

(ii) Under factoring, the factor purchases the trade debt and thus becomes a holder for value. But, under discounting the financier acts simply as an agent of his customer and he does not become the owner. In other words, discounting is a kind of advance against bills whereas factoring is an outright purchase of trade debts.

(iii) The factors may extend credit without any recourse to the client in the event of non-payment by customers. But, discounting is always made with recourse to the client.

(iv) Account receivables under discount are subject to rediscounting whereas it is not possible under factoring.

(v) Factoring involves purchase and collection of debts, management of sales ledger, assumption of credit risk, provision of finance and rendering of consultancy services. But, discounting involves simply the provision of finance alone.

(vi) Bill discounting finance is a specific one in the sense that it is based on an individual bill arising out of an individual transaction only. On the other hand, factoring is based on the 'whole turnover' i.e., a bulk finance is provided against a number of unpaid invoices.

(vii) Under discounting, the drawee is always aware of the bank's charge on receivables. But, under undisclosed factoring everything is kept highly confidential.

(viii) Bill financing through discounting requires registration of charges with the Registrar of Companies. Infact, factoring does not require such registration.

(ix) Discounting is always a kind of "in-balance sheet financing". That is, both the amount of receivables and bank credit are shown in the balance sheet itself due to its with recourse' nature. But, factoring is always "off-balance sheet financing".

14.9 COST AND BENEFITS OF FACTORING

The cost of factoring comprises of two aspects namely finance charges and service fees. Since the factor provides 80% of the invoice as credit, he levies finance charges. This charge is normally the same interest rates which are in vogue in the banking system. Factoring is a cheap source because the interest is charged only on the amount actually provided to the client as repayment of his supplies. Apart from this financial charge, a service charge is also levied. This service fees is charged in proportion to the gross value of the invoice factored based on sales volume, number of invoices, work involved in collections etc. Generally, the factor charges a service fee on the total turnover of the bills. It is around 1%. If the bills get paid earlier, service charges could be reduced depending upon the volume of work involved.

The benefits of factoring to the business are savings in cost of credit administration and cost of bad debt.

A business concern has to evaluate the cost and benefit to arrive at a decision before using the factoring service.

Illustration

A manufacturing concern has a total sales of Rs.16,00,000 and its average collection period is 90 days. The past experience indicates a bad debt loss around 1.5% of credit sales. The company spends Rs.25,000 on credit administration and collection. A factor is prepared to buy the firm's receivables by charging 2% commission. The factor

will pay advance receivable at an interest of 18 per cent after withholding 10 per cent as reserve.

Calculate the cost and benefit to the company and also effective rate of annual cost of factoring

Cost and Benefit

Credit Sales	=	Rs.16,00,000
Average Collection Period	=	90 Days
Average receivables	=	Rs.4,00,000
Factoring commission	=	4,00,000 ---------- x 2 / 100
	=	Rs. 8,000
Reserve	=	4,00,000 ---------- x 10 / 100
	=	Rs. 40,000
Amount available for advance	=	4,00,000 – 8,000 – 40,000
	=	Rs. 3,52,000
Interest on advance	=	3,52,000 x 18 x 90 ---------- / 100 x 360
	=	Rs. 15,840
Advance to be paid	=	Rs. 3,52,00 – 15,840
	=	Rs. 3,36,160

Savings : (Annual)

Cost of credit administration			=	Rs. 25,000
Cost of Bad debts	=	16,00,000 x 1.5		Rs. 24,000
		----------	=	----------
		100 x 360		Rs. 49,000
Cost (Annual)				
Factoring commission	=	8,000 x 360		
		----------	=	Rs. 32,000
		90		
Interest Charge	=	15,840 x 360		
		----------	=	Rs. 63,360
		90		
Total Cost	=	32,000 + 63,360	=	Rs. 95,360
Net cost of factoring	=	95,360 – 49,000	=	Rs. 46,360
Rate of Annual Cost	=	46,360 x 100		
		----------	=	13.79%
		3,36,160		

14.10 BENEFITS OF FACTORING

Factoring offers a number of benefits to the clients. Some of the important benefits are :

(i) Financial Service

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. This has been a great handicap to the small and medium scale manufacturers because they have to wait for 3 months to 9 months to realize their debts. In the meantime, the business may suffer due to want of funds. Infact, many business concerns fail more as a result of inadequate cash flow than anything else. The key to successful working capital management lies in the ability of an enterprise to convert sales

into cash flow and the speed at which it is done. The major benefit of the factoring service is that the clients will be able to convert their trade debts into cash upto 80% immediately as soon as the credit sales are over. They need not wait for months together to get cash for recycling.

Another major advantage is that there are no constrains by way of fixed limits as in the case of cash credit or O.D. As sales grow, the financial assistance also grow and both are directly proportional to each other.

The greatest advantage is that factoring assures immediate cash flow. When the cash position improves, the client is able to make his purchases on cash basis and thus, he can avail of cash discount facilities also.

(ii) Collection Service

Collection of debts is another problematic area for many concerns. It is found that over 60% of the total sales of the SSI sector and over 50% of total sales of the medium and large scale sector are made on “On Account Terms of Payment” i.e. credit sales. It means that collection of debts becomes an important internal credit management and it requires more and more time. So, industrialists cannot concentrate on production. Delay in collection process often leads to delay in production and supplies. Moreover, the interest cost of financing book debts is also on the increase. Ultimately, it affects the profitability of the company. Now, this collection work is completely taken up by the factoring organization, leaving the client to concentrate on production alone. This is an important service rendered by a factor to his client. The cost of collection is also cut down as a result of the professional expertise of a factor.

(iii) ‘Credit risk’ Service

In the absence of a factor, the entire credit risk has to be borne by the client himself. Bad debts eat away the profits of a concern and in some cases, it may lead to the closure of a business. But, once the factoring relationship is established, the client need not bother about the loss due to bad debts. The factor assumes the risk of default in

payment by customers and thus, the client is assured of complete realization of his book debts. Even if the customer fails to pay the debt, it becomes the responsibility of the factor to pay that amount to the client. It is the greatest advantage of factoring.

(iv) Provision of Expertise 'Sales Ledger Management' Service

Administration of sales ledger is purely an accounting function which can be performed efficiently only by a few. Infact, the success of any organization depends upon the efficiency with which the sales ledger is managed. It requires a specialised knowledge which the client may not possess. But, the client can receive services like maintenance of accounting records, monthly sales analysis, overdue invoice analysis and customer payment statement from the factor. Besides, he maintains contact with customers to ensure that they repay their dues promptly. Thus, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. Thus, factoring offers an excellent credit control for the client.

(v) Consultancy Service

Factors are professionals in offering management services like consultancy. They collect information regarding the credit worthiness of the customers of their clients, ascertain their track record, quality of portfolio turnover, average size of inventory etc., and pass on the same to their clients. It helps the clients avoid poor quality and risky customers. They also advise their clients on important financial matters. Generally no time is available to the client for investigating his customer's credit standing. Now, the factor takes up this work on behalf of his client.

(vi) Economy in Servicing

Factors are able to render very economic service to their clients because their overhead cost is spread over a number of clients. Moreover, their service charges are also reasonable. Factoring is a cheap source of finance to the client because the interest rate is charged only on the amount actually provided to the client, say, for instance, 80% of his

total invoices and not on the total amount of the invoices. Thus, clients are able to get factoring services at economic rates.

(vii) Off-balance Sheet Financing

Factoring is an off-balance sheet means of financing. when the factor purchases the book debts of the client, these debts no longer exist on the current asset side of the balance sheet. It leads to reduction in debts and less collection problems. The client can utilise the money so received to reduce his current liabilities. It means an improved current ratio.

This can be better understood by means of an illustration

Given below is the Balance Sheet of X Co. Ltd.

Balance Sheet before factoring arrangement

Liabilities	Rs.	Assets	Rs.
Bank loan-against stock	5,00,000	Stock	8,00,000
Bank loan-against bills	4,00,000	Receivables	6,00,000
Others	2,00,000	Others	2,00,000
Net working capital	5,00,000		
	16,00,000		16,00,000

Now the current ratio comes to 16,00,000 : 11,00,000 = 1.45 : 1

Now, receivables of Rs.6,00,000 are purchased by the factoring agent. The factor pays 80% cash immediately. So the company gets Rs.4,80,000 which is used for paying

some liabilities like bank loan and others. The amount due from the factor comes to Rs.1,20,000 being 20% of the balance of receivables.

The new balance sheet after factoring arrangement

Liabilities		Assets	
Current Liabilities	Rs.	Current Assets	Rs.
Bank loan-against stock	5,00,000	Stock	8,00,000
Others	1,20,000*	Receivables	
Net working capital	5,00,000	(Due from factor)	1,20,000
		Others	2,00,000
	11,20,000		11,20,000

Now the current ratio comes to 11,20,000 : 6,20,000 = 1.8 : 1

* Note : Bank loan against bills is paid out of Rs.4,80,000 received from the factor. The balance Rs.80,000 is paid to other liabilities. Hence, other liabilities appear as Rs.1,20,000 in the new balance sheet.

(viii) Trade benefits

Availability of ready cash against bills enables the supplier to negotiate better prices for the inputs and also offer finer terms to customers. It ensures a steady flow of inputs on the one hand and better market prospects on the other. Again, factoring enables the supplier to concentrate on production and materials management without bothering about the financial management. Factoring enables clients to offer longer credit facilities to their customers and thus to attract more business. Thus many trade benefits are available under factoring.

(ix) Miscellaneous Service

Generally, factors are able to computerize their operations fully. So they are able to render prompt service at reasonable rates. They spend more on M.I.S. analysis. They also build bigger credit library of debtors by means of collecting information about new debtors.

Thus, improved cash flow through realization of trade debts by factoring, efficient follow up of collections, computerized sales ledger maintenance and the competitive rates are the main benefits of factoring.

14.11 FACTORING IN INDIA

In India, the idea of providing factoring services was first thought of by the Vaghul Working Group. It had recommended that banks and private non-banking financial companies should be encouraged to provide factoring services with a view to helping the industrialists and traders to tide over their financial crunch arising out of delays in the realisation of their book debts. The RBI subsequently constituted a study group in January 1988 under the chairmanship of Mr. C.S. Kalyansundaram, former Managing Director of the SBI, to examine the feasibility of starting factoring services. On the recommendation of the committee, the Banking Regulations Act was amended in July 1990 with a view to enabling commercial banks to take up factoring services by forming separate subsidiaries.

In the public interest and in the interest of banking policy, the RBI is of the view that :

(i) The banks should not directly undertake the business of factoring.

(ii) The banks may set up separate subsidiaries or invest in factoring companies jointly with other banks.

(iii) A factoring subsidiary or a joint venture factoring company may undertake the factoring business. But, they should not finance other factoring companies.

(iv) The banks can invest in the shares of factoring companies not exceeding 10% of the paid up capital and reserve of the bank concerned.

But, in February, 1994, the RBI has permitted all banks to enter into factoring business departmentally. Perhaps, this step would have been taken with a view to giving further impetus to the factoring system. Since factoring requires special skills and infrastructure, the RBI has further stipulated that :

(i) Factoring activities should be treated on par with loans and advances and should accordingly be given risk weight of 100 per cent for calculation of capital to risk asset ratio.

(ii) A bank's exposure shall not exceed 25% of the bank's capital funds to an individual borrower and 50% to a group of borrowers. Factoring would also be covered within the above exposure ceiling along with equipment leasing and hire purchase finance.

(iii) Factoring services should be provided only in respect of those invoices which represent genuine trade transactions.

In India, the factoring service was first started by the State Bank of India in association with the Small Industries Development Bank of India, Union Bank of India, State Bank of Sourashtra and State Bank of Indore. The pioneering factoring company founded by the SBI is called "SBI Factors and Commercial Services Pvt. Ltd. (SBI FACS)". It was started in July 1991 with a subscribed capital of Rs.25 crores. It has been allotted the Western Zone composing of Maharashtra, Gujarat, Goa, Madhya Pradesh, The Union Territories of Dadra, Nagar Haveli, Daman and Diu. Similarly, the RBI has allotted the Southern Region to the Canara Bank, the Northern Region to the Punjab National Bank and the Eastern Region to the Allahabad Bank for providing necessary factoring services to the clients of those regions. This zonal restriction has been removed

by the RBI in 1993. In South, Canara Bank has already established Can Factors Ltd. Now, these two factoring companies can operate in the centers outside their given zones. Besides the above, some non-banking companies also have made a bid for entering into factoring services. Thus factoring service has got a very bright future in India due to its superiority over other forms of financing.

14.12 FORFEITING

Forfeiting is another source of financing against receivables like factoring. This technique is mostly employed to help an exporter for financing goods exported on a medium term deferred basis.

The term ‘forfeit’ is a French word denoting ‘to give something’ or ‘give up one’s rights’ or ‘relinquish rights to something’. In fact, under forfeiting scheme, the exporter gives up his right to receive payments in future under an export bill for immediate cash payments by the forfeitor. This right to receive payment on the due date passes on to the forfeitor, since, the exporter has already surrendered his right to the forfeitor. Thus, the exporter is able to get 100% of the amount of the bill minus discount charges immediately and get the benefits of cash sale. Thus, it is a unique medium which can convert a credit sale into a cash sale for an exporter. The entire responsibility of recovering the amount from the importer rests with the forfeitor. Forfeiting is done without any recourse to the exporter i.e. in case the importer makes a default, the forfeitor cannot go back to the exporter for the recovery of the money.

Forfeiting has been defined as “the non-recourse purchase by a bank or any other financial institution, of receivables arising from an export of goods and services.

14.13 FACTORING VS. FORFEITING

Both factoring and forfeiting are used as tools of financing. But there are some differences :

(i) Factoring is always used as a tool for short term financing whereas forfeiting is for medium term financing at a fixed rate of interest.

(ii) Factoring is generally employed to finance both the domestic and export business. But, forfeiting is invariably employed in export business only.

(iii) The central theme of factoring is the purchase of the invoice of the client whereas it is only the purchase of the export bill under forfeiting.

(iv) Factoring is much broader in the sense it includes the administration of the sales ledger, assumption of credit risk, recovery of debts and rendering of consultancy services. On the other hand, forfeiting mainly concentrates on financing aspects only and that too in respect of a particular export bill.

(v) Under factoring, the client is able to get only 80% of the total invoice as 'credit facility' whereas the 100% of the value of the export bill (of course deducting service charges) is given as credit under forfeiting.

(vi) Forfeiting is done without recourse to the client whereas it may or may not be so under factoring.

(vii) The bills under forfeiting may be held by the forfeitor till the due date or they can be sold in the secondary market or to any investor for cash. Such a possibility does not exist under factoring.

(viii) Forfeiting is a specific one in the sense that it is based on a single export bill arising out of an individual transaction only. But, factoring is based on the "while turnover" i.e., a bulk finance is provided against a number of unpaid invoice.

14.14 WORKING OF FORFEITING

In a forfeiting transaction, the exporter is 'the client' and the financial institution is called 'the forfeitor' and the importer is 'the debtor'. When an exporter intends to export goods and services, he approaches a forfeitor and gives him the full details of his likely

export dealing such as the name of the importer, the country to which he belongs, the currency in which the export of goods would be invoiced, the price of the goods and services etc. He discusses with him the terms and conditions of finance. If it is acceptable, a sale contract is signed between the exporter and the importer on condition that the payment should be made by the importer to the forfeitor.

As usual, bills or promissory notes are signed by the importer. Such notes are guaranteed by the importer's bank and forwarded to the exporter's bank. Generally, such notes would be released to the exporter only against shipping documents. When goods are exported, the shipping documents are handed over to the exporter's bank. The exporter's bank, then forwards the shipping documents to the importer's bank after releasing the notes/bills to the exporter. These documents finally reach the hands of the importer through his bank.

Thereafter, the exporter takes these notes to the forfeitor who purchases them and gives ready cash after deducting discount charges.

Cost of Forfeiting

The cost of forfeiting finance is always at a fixed rate of interest which is usually included in the face value of the bills or notes. Of course, it varied depending upon the arrangements duration, credit worthiness of the party, the country where the importer is staying, the denomination of the currency in which the export deal is to be done and the overall political, economic and monetary conditions prevailing in the importer's country. Since the forfeitor has to assume currency fluctuation risk, interest rate fluctuation risk and the country's risk, he charges a fee and obviously it varies according to the risk factor involved in the deal.

14.15 BENEFITS OF FORFEITING

The following are the benefits of forfeiting :

(i) **Profitable and Liquid :** From the forfeiter's point of view, it is very advantageous because he not only gets immediate income in the form of discount charges, but also, can sell them in the secondary market or to any investor for cash.

(ii) **Simple and Flexible :** It is also beneficial to the exporter. All the benefits that are available to a client under factoring are automatically available under forfeiting also. However, the greatest advantage is its simplicity and flexibility. It can be adopted to any export transaction and the exact structure of finance can also be determined according to the needs of the exporter, importer and the forfeitor.

(iii) **Avoids Export Credit Risks :** The exporter is completely free from many export credit risk that may arise due to the possibility of interest rate fluctuations or exchange rates fluctuations or any political upheaval that may affect the collection of bills. Forfeiting acts as an insurance against all these risks.

(iv) **Avoids Export Credit Insurance :** In the absence of forfeiting, the exporter has to go for export credit insurance. It is very costly and at the same time it involves very cumbersome procedures. Hence, if an exporter goes for forfeiting, he need not purchase any export credit insurance.

(v) **Confidential and Speedy :** International trade transactions can be carried out very quickly through a forfeitor. It does not involve much documentary procedures. Above all, it is very confidential. The speed and confidentiality with which deals are made are very beneficial for both the parties namely the exporter and the importer. No banking relationship with the forfeitor is necessary, since, it is a one time transaction only.

(vi) **Suitable to all kinds of export deal :** It is suitable to any kind of goods – whether capital goods exports or commodity exports. Any export deal can be subject to forfeiting.

(vii) Cent per cent Finance : The exporter is able to convert his deferred transaction into cash transaction through a forfeitor. He is able to get 100 per cent finance against export receivables.

(viii) Fixed Rate Finance : Forfeiting provides finance always at a fixed rate only. So, there is no need to enter into any hedging transactions to protect against interest rate and exchange rate risks.

14.16 DRAWBACKS OF FORFEITING

The following are the drawbacks of forfeiting :

(i) Non-availability for short and long periods : Forfeiting is highly suitable to only medium term deferred payments. Forfeitors do not come forward to undertake forfeit financing for long periods, since, it involves much credit risks. Similarly, it cannot be used for availing short term credit or contracts involving small amounts because they do not give rise to any bills or notes. Hence, exporters who require short term and long term credit have to seek some other alternative source.

(ii) Non-availability of financially weak countries : Similarly, forfeitors generally do not come forward to undertake any forfeit financing deal involving an importer from a financially weak country. Generally, the forfeitor has a full grasp of the financial and political situation prevailing in different countries, and hence, he would not accept a deal if the importer stays in a risky country. In exceptional cases, it can be undertaken at a higher price.

(iii) Dominance of western currencies : In international forfeiting, transactions are dominated in leading western currencies like Dollar, Pound Sterling, Deutshe Mark and French and Swiss Franchs. Hence, our trade contracts have to be in foreign currencies rather than in Indian rupees.

(iv) Difficulty in procuring international bank's guarantee : Forfeitors do not normally finance an export deal unless it is supported by an unconditional and

irrevocable guarantee from an international bank known to the forfeitor. Generally, it is the duty of the exporter to procure a guarantee of this kind and it is a stupendous task for an exporter to do so.

14.17 FORFEITING IN INDIA

Forfeiting, as a source of finance, has gained substantial momentum abroad. Though it had its origin in 'Zurich', it has been well established in all the financial centers of the world. Some of the important forfeiting centers are London, Zurich, Hong Kong, Singapore and Frankfurt. It has become a popular source of finance among Europeans.

In India, forfeiting is slowly emerging as a new product in the liberalized financial market. It was approved by the Union government only in January, 1994. The existing scheme available for exporters like concessional finance by commercial banks, insurance cover against export credit risks by ECGC etc. are available mainly to large and well established exporters. In this context, forfeiting may be a real boon to the small, as well as, new exporters.

In India, forfeiting is done by the EXIM Bank. The minimum value of a forfeiting transaction is Rs.5,00,000/-. A special form of pronote/bill has to be used for forfeiting transactions. An Indian exporter who wants to avail of this service has to approach the EXIM bank through his bank. The EXIM bank would obtain the forfeiting quotation from the forfeiting agency abroad. Based on this, the exporter would work out his price to be quoted to the importer. If the importer accepts the price and the payment terms, the contract would be finalized and executed. The exporter would then get cash through forfeiting arrangements for which he has to enter into a separate contract with the forfeitor through the EXIM bank.

However, in order to encourage forfeiting finance business, it is necessary to designate export contracts in leading international currencies. In the wake of economic liberalization and opening of our economy to the global market, there are good prospects

for forfeiting business in India. To promote forfeiting business, it is essential that we should denominate our trade contracts in foreign currencies rather than in Indian rupees. Now, since the rupee has gained strength, it is time for us to denominate our trade obligations in foreign currencies so that the pace of forfeiting business may be accelerated mainly to boost our export trade.

14.18 SUMMARY

Factoring is a financial service whereby an institution, called the factor, undertakes the task of realizing, accounts receivables, book debts and bill receivables, and in the process provides financial accommodation to traders. Factoring is of different types such as domestic factoring, export factoring, cross border factoring, with recourse factoring, without recourse factoring, etc. Many advantages accrue from factoring such as easy and convenient mode of short-term financing for a trader, facilitating accelerated cash flows, inculcating credit discipline, facilitating information flow, etc. Important players in the realm of factoring are the buyer, the seller, and the factor. A factor renders several functions, such as sales ledger administration, provision of collection facility, financing trade debts, credit control, protection and advisory services. Factoring costs include commission for collection of book debts and the interest charges for the credit period. RBI has come out with guidelines designed to regulate the functioning of the factors in India. Accordingly, factoring can be started as an associate business of a banking company, with prior permission from RBI. Developments in Indian factoring scenario started taking place with the recommendation of the Kalyanasundaram committee on factoring. At present factoring is undertaken by a limited number of banks on a small scale such as SBI and Canara Bank, in addition to certain institutions in the private sector. A form of financing of receivables arising from international trade transactions is known as ‘forfaiting’. Forfaiting essentially involves a non-recourse bill discounting.

14.19 KEYWORDS

Factoring: A financial service that undertakes to collect account receivables on behalf of the seller of goods and makes advance to a trader on that basis.

Forfaiting: Financing of receivables arising from international trade.

Factor: A bank or a financial institution that renders the factoring service.

Without Recourse Factoring: Arrangement whereby the factor has no recourse to the client firm in the event of non-recoverability of book debts.

14.20 SELF ASSESSMENT QUESTIONS

1. Define factoring and state how is it superior to bill financing.
2. Explain the different types of factoring and their significance.
3. Discuss the various services rendered by factoring intermediaries.
4. Highlight the role of forfeiting as a source of finance.
5. Differentiate between factoring and forfeiting and explain the status of forfeiting in India.

14.21 SUGGESTED READINGS

Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.
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